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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/16

10:00 a.m., February 28, 1994

Contents

Executive Board Attendance

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	M. Sirat
	P. Cailleteau, Temporary
	D. Desruelle, Temporary
	L. Fontaine, Temporary
J. Bergo	E. Srejber
	A. Cserés, Temporary
	F. Moss, Temporary
H. Evans	J. Dorrington
	A. G. Cathcart, Temporary
H. Fukui	S. Ishida, Temporary
	N. Prasad, Temporary
J. E. Ismael	K.-T. Hetrakul
	K. Link
A. Kafka	J. C. Jaramillo
	B. M. Lvin, Temporary
G. Lanciotti	R. Bessone Basto, Temporary
K. Lissakers	J. M. Abbott, Temporary
	M. W. Ryan, Temporary
R. Marino	
	S. Rouai, Temporary
L. J. Mwananshiku	J. M. Jones, Temporary
	O. Havrylyshyn
C. Santos	Y.-M. T. Koissy
	E. Wagenhoefer
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	G. F. Murphy
	R. Rainford, Temporary
E. L. Waterman	A. M. Tetangco, Jr.
Zhang M.	Wei B.
	Wang X., Temporary
	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant
S. W. Tenney, Assistant

Also Present

IBRD: H. Codippily, East Asia and Pacific Regional Office; S. Sokol, A. Thorne, Latin America and Caribbean Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; C. Brachet, K. Driessen, U. Fasano-Filho, S. L. Rothman, U. Von Allmen. External Relations Department: S. J. Anjaria, Director. Fiscal Affairs Department: A. Garcia. Legal Department: J. M. Ogoola. Policy Development and Review Department: B. J. Aitken, M. Allen, A. Basu, V. Galbis, C. Puckahtikom, J. F. van Houten. Research Department: G. M. Milesi-Ferretti, J. E. Roldos. Secretary's Department: A. Leipold. Southeast Asia and Pacific Department: K. Saito, Director; J. Hicklin, D. J. Robinson, E. Sidgwick. Statistics Department: S. P. Quin, R. J. Zytek. Western Hemisphere Department: S. T. Beza, Counsellor and Director; C. M. Loser, Deputy Director; J.-P. Amselle, J. Gold, A. M. Jul, A. M. Leone, R. E. M. Randall, C. Richardson, L. Schmitz, S. Sheybani, J. Thornton, E. S. Williams. Advisors to Executive Directors: J. O. Aderibigbe, A. Chang Fong, T. K. Gaspard, Y.-H. Lee, N. Mancebo, M. F. Melhem, P. A. Merino, M. J. Mojarrad, A. Raza, B. A. Sarr, J. R. Suárez, A. Törnqvist, J. W. van der Kaaij. Assistants to Executive Directors: S. Al-Huseini, R. N. A. Ally, D. A. Barr, J. M. Burdiel, C. D. Cuong, M. Dzervite, A. Galicia, G. H. Huisman, C. Imashev, T. Kanada, E. Kouprianova, W. C. Keller, T.-M. Kudiwu, K. J. Langdon, G. J. Matthews, S. C. McDougall, S. del C. Olgiati, J. Pesola, H. Petana, C. F. Pillath, S. K. Regmi, D. Saha, A. Sighvatsson, L. Tase, R. Von Kleist, A. Wechsberg.

1. MEXICO - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Mexico (SM/94/31, 2/1/94; and Cor. 1, 2/22/94). They also had before them a statistical annex (SM/94/41, 2/14/94).

Mr. Marino made the following statement:

The Mexican authorities are in broad agreement with the staff appraisal and wish to extend their appreciation to the staff and management for their insight and support, particularly during the periods of financial turbulence that occurred during the year.

Over the past 5 years, the main macroeconomic variables of the Mexican economy strengthened considerably, laying the foundation on which the economy can grow at sustainable rates. The inflation rate has been converging with that of our main trading partners; public finances have ceased to exert inflationary pressures; public debt, both external and domestic, has been reduced drastically; and debt-service payments declined to a small proportion of public sector expenditure, allowing for significant increases in social sector outlays directed toward education, health, and infrastructure. Also, structural changes in many areas have dismantled excessive regulations and protection that obstructed the efficient functioning of the economy. In only a few years Mexico has become one of the most open economies in the world.

The profound structural changes that have been implemented in the Mexican economy and the process of stabilization have undoubtedly carried some transition costs for different sectors of society. On the one hand, the reduction in inflation has probably implied higher real interest rates than those expected to prevail in the long term. On the other hand, the process of deregulation and opening of the economy has produced a microeconomic adjustment without precedent in the country. All these forces have led to a temporary slowdown in economic activity that should begin to correct itself during 1994. The significant amounts of investment undertaken by the private sector over the past five years, coupled with the increases in productivity in many industries, should soon be reflected in higher rates of growth in production and employment and continued dynamism of exports.

During 1993, the salient features of the Mexican economy were the reduction of inflation to 8 percent--its lowest level in more than two decades--and the deepening of the structural transformation of the economy, including the constitutional amendment that grants autonomy to the central bank, the new foreign investment law, and the ratification of the North American Free Trade Agreement (NAFTA). The fiscal accounts continued to be strong, with the overall fiscal balance registering a small surplus, and the balance of payments strengthened. Non-oil exports grew at a rapid pace, contributing to a narrowing of the trade balance and the current account deficit. Nevertheless, the uncertainties derived from the process of ratification of NAFTA, rigidities in inflationary expectations, and a more cautious credit policy by commercial banks in light of a deterioration of their loan portfolios discouraged investment and consumption expenditure leading to a marked slowdown in economic activity and employment growth.

During 1993, inflation reached single-digit levels for the first time in the past 21 years, placing Mexico closer to the goal of reaching an inflation rate equal to that of its main trading partners. This has been possible through prolonged efforts of fiscal consolidation, prudent management of monetary policy, and a strengthening of the exchange rate regime. The Mexican authorities consider attaining price stability an indispensable precondition on which to achieve the fundamental objectives of economic policy: sustained high-quality growth that is accompanied by high levels of employment and more equitable income distribution.

For the second year in a row, in 1993 the overall fiscal balance recorded a surplus of 0.7 percent of GDP. The improvement in public finances over the past years has contributed to the reduction of inflation and, by reducing debt-service expenditure, it has allowed a substantial increase in social expenditure. While in 1988 interest payments on public debt amounted to 17.7 percent of GDP, in 1993 they represented only 3 percent of GDP. Public expenditures have been declining as a proportion of GDP since 1988. However, public expenditures in the social sectors have increased from 6.3 percent of GDP in 1988 to 10.2 percent in 1993 and now represent close to 54 percent of total programmed expenditure.

Monetary policy was conducted in an atmosphere characterized by a slowdown of economic activity, declining inflation, substantial capital inflows, and jittery financial markets influenced by the uncertainties derived from the process of ratification of NAFTA. Monetary policy continued to pursue its central objective of promoting price stability. Operationally, the Bank of Mexico seeks to produce an increase in base money, in line with the expected growth in demand for this aggregate. Therefore, an active sterilization policy was required to control inflationary pressures derived from the growth of base money resulting from the substantial capital inflows received during the year. Monetary policy also sought to avoid wide swings in interest rates, without interfering with the fundamental trends in markets.

Exchange rate policy continued to contribute to the goal of reducing inflation while maintaining the flexibility required to address temporary disturbances in the foreign exchange market. These twin goals were achieved through the gradual widening of the band within which the exchange rate can move.

The size of the current account deficit in Mexico has been a source of concern for market analysts who question its sustainability over the medium term and use it as an indicator of loss of external competitiveness for Mexican products. On previous occasions we have argued--and continue to believe--that the current account deficit reflects mainly the improved investment opportunities in Mexico that have been financed by foreign capital inflows and the opening of the Mexican economy to foreign trade. The dynamic behavior of non-oil exports, and particularly manufactured exports during the period 1985-93, provides evidence of the competitiveness of Mexican exports. From 1985 to 1993, non-oil exports grew at an average annual rate of 17.8 percent, while manufactured exports rose by an annual average of 19.4 percent. The rapid increase of exports, despite the significant real appreciation of the exchange rate, the increase in real average remunerations in the manufacturing sector, and the slow growth of foreign demand, reflects the importance and role of the structural reforms in promoting competitiveness in Mexico and is part and parcel of the microeconomic transformation of the economy.

After several years of sustained trade liberalization, it has become clearer that the supply of exports is promoted by allowing imports of capital and intermediate goods at international prices. This also stimulates a more efficient use of resources, which allows improved specialization according to comparative advantages and produces benefits derived from economies of scale.

During 1993, important structural changes were implemented in diverse areas. The objective behind these changes is to continue to improve the institutional framework so that the productive process can become more efficient and competitive. In this area, the following actions stand out:

First, the constitutional amendment that grants autonomy to the central bank: Under the amendment, the Bank of Mexico's main mandate is to maintain price stability; it cannot extend credit to the public sector; and it will have a governing body that cannot be easily removed.

Second, the changes in financial legislation that take into account the need for greater supervision of financial intermediaries in light of the privatization of commercial banks; and additionally, after many years, new banks will be allowed to be established in Mexico: These actions are intended to promote efficiency and competition in the financial sector while safeguarding the interest of depositors and users of credit. Moreover, under NAFTA, affiliates of financial institutions from Canada and the United States will enter into the Mexican market, thus providing additional competition in the financial system.

Third, the ratification of NAFTA: With the entering into effect of NAFTA, the opening of the Mexican economy will continue and competition will be enhanced. It is expected that access of Mexican goods to the U.S. and Canadian markets will improve and that foreign direct investment in Mexico will be promoted.

Fourth, the ratification of a new foreign investment law: Under the new law, the scope for foreign investment in Mexico is being expanded and procedures simplified.

Fifth, other important structural changes include the link of minimum wages to increases in productivity in the economy under the Pact for Stability, Competitiveness, and Employment (PECE); in education, a new law was enacted that stipulates the obligations of the state in this area and the attributions of the different levels of government; the modification of the support polices for agriculture that seek to promote the role of market prices as a guide for agricultural production and provide direct benefits to low-income farmers; the enactment of the Federal Competition Law and the creation of the Competition Commission designed to combat monopolistic practices.

The structural changes that have been taking place, by contributing to the elimination of distortions and other market imperfections, promote the reallocation of resources between the productive sectors and the efficiency of the economy. As mentioned earlier, one of the effects has been the rapid growth of non-oil exports in spite of unfavorable external market conditions, which has placed the Mexican economy among those experiencing more rapid growth of exports.

The program for 1994 is based on the guidelines established in the context of the wage and price pact (PECE), renewed since October 1993, and on the budget for 1994 sent to Congress in November 1993. In formulating the objectives for 1994, the progress achieved in stabilizing the economy as well as the structural changes undertaken over the past years were taken into account. The main objectives for 1994 are the following:

First, to consolidate the progress toward reducing inflation and to continue the convergence toward the levels of our main trading partners. To that effect the inflation target for 1994 is 5 percent.

Second, to promote the recovery of economic activity and employment through actions that fortify domestic production. For 1994, real GDP is expected to grow by 3 percent.

Third, to increase the purchasing power of workers, particularly those at the lower income levels.

Fourth, to promote higher levels of welfare by increasing the budgetary resources devoted to the social sectors.

Fifth, to continue with the structural transformations that help increase the productivity of the economy so as to allow firms to compete successfully in an open economy.

The Mexican authorities consider that the best way to foster these objectives is by maintaining strict fiscal discipline and a sound macroeconomic framework. In that context, and taking into account the progress in reducing public sector debt as well as the need to support economic growth, the fiscal target for 1994 is a balanced budget. Within this framework, the Mexican Government will continue to increase the share of expenditure in the social sectors. Additionally, tax measures have been implemented that increase the disposable income of low-wage earners and that encourage private investment. Monetary policy will continue to foster price stability. Nevertheless, with the dissipation of many of the uncertainties that prevailed during 1993, real interest rates are expected to decline.

The fall in domestic interest rates, a less uncertain environment for private investors, and the work out of the transitory recessionary forces derived from the structural transformation should contribute to achieving the growth objective for 1994.

Mr. Havrylyshyn made the following statement:

What we all hoped for during last year's discussion on Mexico actually happened in 1993: inflation came down to 8 percent, the first time since 1972 that the rate is not a double-digit figure; and private savings increased by 2 percent of GDP, which is an outstanding and truly welcome performance. This is excellent proof that the Mexican authorities are definitely on the right track.

Nevertheless, it is also apparent that the final destination has not yet been reached. While capital inflows are expected to remain fairly large in the coming years, credibility in the international financial markets still does not seem to have been fully established. Some indicators show a surprising picture. For example, the Mexican country-risk rating produced by

The Economist has not improved since 1988 despite the successful adjustment efforts. A possible explanation, also mentioned by Mr. Marino, could be that the external current account, despite the encouraging deficit reduction in 1993, is still viewed as relatively unsustainable. A strong and growing economy can sustain such deficits for a long time because it can continue to repay its obligations, maintaining creditworthiness and attracting new investments and credits. But while private investments in Mexico over the past few years, 1986-93, have been mainly financed by an increase in the current account, in the economies of Southeast Asia the contribution came also from domestic--private and public--savings in addition to foreign savings. This shows that domestic and foreign savings are not substitutes but complements. The same factors that attract capital inflows will also encourage domestic savings. If that is not the case something is missing. I would like to hear from the staff how it assesses the increase in private savings in 1993. Was this a structural and durable improvement or was it a temporary phenomenon owing to specific circumstances in 1993 such as low real economic growth and uncertainties about NAFTA?

There is another curiosity with regard to the Mexican economy that might be worth discussing in more detail. Despite continued growth of exports and investments, real GDP growth does not seem to get off to a determined start compared with other upper-middle-income countries. Average annual real GDP growth over the five-year period 1989-93 lies well under 3 percent, which is low indeed compared with Southeast Asian countries, but also with Argentina and Chile. A look at incremental capital/output ratios (ICOR) shows that Mexico scores regrettably high over the period 1990-92 with a ratio of nearly 7, whereas, for instance, Thailand, Malaysia, Korea, and Chile are at or well below 5. This suggests that in Mexico for some reason investments still cannot generate a level of economic growth similar to that in other countries. In the staff's medium-term scenarios for Mexico, an improvement of the ratio to 5 is implied, but it is not entirely clear to me how such an improvement in ICOR and the consequent increase in real GDP growth can be explained or if further improvement toward the levels of high-growth economies can be expected. Mr. Marino attributes the expected GDP growth partly to specific Mexican circumstances. But he also mentions factors or policies that have played a role in comparable countries--for instance, significant microeconomic adjustment and restrictive monetary and fiscal policy. I would like to ask the staff or Mr. Marino to elaborate somewhat on this issue. They may also want to take into account the opinion of the authorities that the recent slowdown of economic growth is mainly the result of the efforts to reduce the rate of inflation. This made me somewhat suspicious as to whether this might be a reflection of "adjustment fatigue."

It is obvious that a further decline in inflation rates is warranted. To this end, the new wage-price pact agreed with business and labor, which provides for wage increases in line with projected inflation and productivity increases, is very helpful. Nevertheless, I have some questions about the mechanism of this pact. I understand that the productivity increase of the public sector is set at 2 percent. This raises the question as to whether the pact can be considered strong enough to allow a surge in real GDP growth without an increase in inflation. Also, we wonder how the mechanism allows for the possibility that inflation and/or productivity targets are not met.

On exchange rate policy, as in last year's Article IV consultation, I continue to have some difficulties with the daily adjustment of the band ceiling. If it is true, as the authorities say, that investors were well aware of the Government's intentions to preserve relative exchange rate stability, a decision not to widen the band could have been sold to the markets as a sign of the authorities' commitment. I regret that the authorities did not take this opportunity, because the wider band can put renewed pressure on inflation. Also, the emphasis on the Bank of Mexico being ready to continue to intervene does not appear to be very impressive. To conclude, as has become clear in recent discussions on, for example, Argentina and Indonesia, only a convincing lowering of inflation can ensure an effective stable exchange rate, which can in turn help to maintain low inflation.

Ms. Lissakers made the following statement:

We welcome the opportunity to comment on the continuing progress made by Mexico in modernizing and strengthening its economy. A dramatic transformation of the Mexican economy is under way and one can only admire and applaud the economic vision and political courage of Mexico's leadership in carrying forward its program.

In 1993, Mexico took a number of important steps to advance and to strengthen the reform program. Of particular importance was the recent approval of legislation ensuring the independence of the Bank of Mexico. Greater autonomy for the monetary authority should enhance credibility and pay important dividends in further reducing inflationary expectations and the associated interest premiums on debt. We also commend the skillful handling of exchange pressures that arose when U.S. congressional passage of the NAFTA legislation seemed in doubt.

New laws in the areas of foreign investment and the stock market should contribute to further efficiency gains and reinforce investor confidence. Removal of restrictions on foreign investors should encourage a shift of foreign capital flows from portfolio to more stable direct investment. Better supervision and more competition in the financial services sector should further enhance the intermediation process and reduce spreads.

Building on the privatization program, now winding down, efforts to expand private sector participation in infrastructural projects and their management offer a means of meeting more quickly transportation and power generation needs, boosting efficiency, and limiting the call on fiscal resources. We are pleased to see that the Government plans to take some final steps in the privatization area, including with regard to PEMEX and the transport sector.

Last but not least, approval of NAFTA in Mexico and in the United States provides further assurance for both foreign and domestic investors that Mexico's economic opening is irreversible and opens new trade and investment opportunities that should benefit all three North American economies.

These measures build on the far-reaching reform process under way, which has had a dramatic and salutary effect on Mexico's public sector and monetary performance. As Mr. Marino notes, the reduction in external and domestic public debt as a share of GDP has resulted in substantial declines in interest expenses from 17.7 percent of GDP in 1988 to 3 percent in 1993--obviously, the decline in world interest rates overall has also been helpful--freeing up resources for much-needed social projects. Inflation is down to single digits from 132 percent in 1987.

Unfortunately, improvement in the private economy and overall economic performance is not yet as apparent, and that is cause for some concern. Growth in the 1990s has remained sluggish by developing country standards--and certainly compared with the very dynamic South Asian economies--and is far too low to produce any significant improvement in the standard of living of the majority of the Mexican people after the extreme deprivations of the 1980s.

The domestic saving rate is still low. Increases in investment have been financed with foreign savings, and the size of the current account deficit is a matter of concern. More volatile and interest-rate-sensitive capital inflows still predominate. Portfolio investment is far larger than direct investment inflows, and one wonders what the impact would be of a significant increase in dollar interest rates. A larger share of investment should come out of domestic private savings, and like Mr. Havrylyshyn, I would ask the staff to comment on whether the sudden surge in domestic private savings in 1993 is likely to continue or whether it is simply a temporary phenomenon owing to the slow growth of the domestic economy. We would hope that the conclusion of NAFTA and further consolidation efforts by the Government would encourage a significant surge in direct investment inflows, which would help to increase Mexico's productive capacity--the key to the growth path of the future and to price stability.

Mexico's export performance has improved, with significant diversification away from petroleum-related products. But a question remains as to whether the economy has sufficient capacity to maintain a high level of exports if domestic demand recovers strongly in the next couple of years, or will there be renewed inflationary pressures and a deterioration in the current account? It would be useful in this regard to have some indication of capacity utilization, unemployment, and the output gap in the economy.

Similarly, some discussion of the employment picture would have been in order. Many economists believe that the structural changes now under way, and the opening of Mexico to agricultural and manufacturing imports from the United States, will increase unemployment over the near term. Would the staff comment?

I would also like to see some discussion of the banking system's reliance on dollar funding for domestic assets. Who bears the exchange risk, and how large is it?

This risk notwithstanding, we would disagree somewhat with Mr. Havrylyshyn on the wisdom of widening the exchange bands. Given the peso's strong appreciation and lagging productivity gains in certain areas of the private sector, some depreciation of the peso might be in order to ensure the competitiveness of Mexican exports.

Finally, while this is not a political institution, one cannot deny the close connection between political developments and economic outcomes. Experience--most recently in the former Soviet Union--indicates that economic liberalization can only succeed when the majority of people feel that they share equitably in the rewards and have a say in their government's policies. We strongly endorse the Mexican Government's increased focus on social programs and rise in budgetary expenditure in this area--an essential part of the economic transformation. We also welcome recent steps to open the political process. We hope for further measures of democratization in 1994 to ensure achievement of the fundamental objectives of Mexican policy, so clearly stated by Mr. Marino: "sustained high-quality growth that is accompanied by high levels of employment and more equitable income distribution."

Mr. Smee made the following statement:

The achievements in recent years of the Mexican authorities in macroeconomic stabilization and structural reforms are simply staggering. Particularly noteworthy are the reduction in inflation from triple to single digits, a fiscal surplus achieved three years running, the major restructuring of Mexico's external debt load, the amendment of the constitution to give greater independence to the central bank, the removal of sizable distortions inherent in massive state intervention through privatization, the opening up of the economy, a significant lowering of import tariffs, and, not without substantial drama, the free trade agreement reached with its northern neighbors.

These achievements enable one to be optimistic about the prospects for the Mexican economy. Nevertheless, I also have some concerns related to competitiveness, the exchange rate, and the balance of payments.

On the balance of payments, the current account deficit has widened by some 3 percent of GDP from 1989 to 5.7 percent in 1993--down 1 percent from 1992--but, as Ms. Lissakers mentioned, this was a slow year for domestic demand growth in the Mexican economy. Looking at the saving/investment relationship, Mexico's use of external savings to supplement its own national savings to fund domestic investment has risen by some 3 percent as well. Such a development in the current account would not be of concern if, as Mr. Marino notes, this increased use of external savings had supported rising private sector investment with profitable rates of return. But Table 3 in the staff report shows that, with net public savings improving by 3 percent of GDP over the same period, net private savings deteriorated by almost 6 percent. Only 0.5 percent represented a rise in the private sector investment share of GDP, while the remaining 5.5 percent represented a fall in private sector savings, which can result from both a rising consumption share--of perhaps 1 percent--and a falling profit share. I will return to this discouraging aspect in discussing competitiveness.

Table 58 in the Statistical Annex contains a series on the real effective exchange rate based on relative unit labor costs. The rate has deteriorated by 50 percent since 1989, and yet the staff report (page 12) states that "the strong expansion in manufacturing exports would indicate that the structural reforms in recent years and wage restraint have compensated sufficiently for the appreciation of the peso (in terms of relative prices) so far." This seems to imply that despite a general, overall substantial loss in competitiveness, manufactured exports have had good growth rates from low levels. One can only imagine what could have been done in the rest of the economy, such as in import-competing industries, without the loss in competitiveness.

This leads me to the determinants of unit labor costs in the economy. I could not find any statistics on productivity in the manufacturing sector or the whole economy. I can imagine, as the staff states, that productivity is rising well in the manufacturing sector. But, with annual output growth in the whole economy averaging about 3 percent a year since 1989, I believe productivity will be low considering the young population and high labor force growth rate.

Mexico's wage and price policies are set out in Appendix III of the Statistical Annex. In 1987, the first social pact was agreed, and seven years later, the pacts are still in use, aimed "at establishing a path for incomes, key prices, and the exchange rate." One can see the usefulness of these types of pact at a time of crisis in order to definitively shift expectations and reduce the output and employment costs of inflation reduction. But are they outgrowing their usefulness, and are they becoming counterproductive? For example, while the real minimum wage declined, real wages in manufacturing increased by over 6 percent a year over the same period. Now, with NAFTA, more than ever Mexico must be competitive. Its overall competitiveness has dropped back to where it was in the early 1980s, hardly a positive comparison. This deterioration has many causes, including price and wage developments internally and the exchange rate externally. These are elements of the various social pacts that continue to this day.

The medium-term forecast provided by the staff projects a rising investment share of GDP, financed increasingly by national savings, particularly the private sector. This is good news, although the use of external savings remains high--at 4 percent of GDP in 1998. This amounts to a need for private capital inflows of some $25 billion, year after year, and the alternative scenarios indicate that the baseline is most susceptible to slower growth in non-oil exports and particularly faster growth in total imports.

These are my concerns. The scenario is already risky, notwithstanding a rise in private sector savings and domestic investment as a share of GDP, with the continued high current account deficit and hence of external savings. Without an improvement in competitiveness, the risk of lower non-oil exports and higher imports rises substantially. This calls for a prudent fiscal policy, a monetary policy focused solely on inflation reduction, a flexible exchange rate policy, and the introduction of market-determined prices and wages.

Mexico has done so much to remove government intervention from markets and open up the economy to the rest of the world. It is time now to complete the process. This brings its own risks--in terms of possible inflationary consequences--but the Mexican economy has developed to the point of integration with the rest of the world, both in goods and services and in capital, where it runs more risk maintaining its present policy stance than going all the way to market determination in the medium term, both domestically and internationally.

Mr. Jaramillo made the following statement:

Mexico continues to make remarkable progress in its stabilization efforts. Doubts have been expressed regarding the sustainability of this process, particularly as the exchange rate tended to appreciate significantly during the initial phase of the disinflation effort, in a similar fashion to that which occurred in several other exchange rate-based stabilization processes of recent vintage. Many observers, including ourselves, saw this outcome as leading to marked losses of competitiveness and, as a result, to unsustainable balance of payments difficulties. It did not. Gains in productivity and cost reductions stemming from structural reform largely compensated for the effects of currency appreciation. Continued export dynamism attests to this effect: as noted in the staff report, non-oil exports increased by over 15 percent during 1993, despite sluggish growth of the world economy, and a similar increase is expected in 1994. If inflation drops to 5 percent this year, as currently envisaged, then the additional productivity gains in the tradables sector originating in continued structural transformation may serve to maintain Mexican competitiveness within the framework of a stable nominal exchange rate.

Of course, even if exports remain "competitive," the size of the current account deficit could be indicating that the balance of payments is still facing problems on the import side. We are not convinced that the Mexican authorities should be overly concerned in this regard at present. So far, financing flows have not been lacking; they have largely been of private origin and there do not seem to exist major distortions inducing such flows. Rather, they have been brought about by the success of the overall policy thrust of the past several years that fostered private investment demand and, consequently, capital goods imports.

We would thus argue that as long as the overall policy thrust remains committed to stability and further removal of structural bottlenecks, as is clearly the case at present, the Mexican current account deficit will be sustainable. As private debt mounts and capital repatriation subsides, financial markets will probably reduce debt flows to Mexico, and capital goods imports should taper off. But even if these results were not to materialize, the bottom line regarding the sustainability of the process lies with the authorities' commitment to adjust policies if required. The Mexican authorities have again expressed this commitment as noted both by the staff and by Mr. Marino, and the experience of the past several years attests to the seriousness of such commitments.

Having said this, we must emphasize that despite the bright prospects faced by Mexico, there is no room for complacency. Inflation still remains above international levels, and failure to reduce it could harbor expectations in domestic and international markets that could adversely affect the country's prospects. Mexico has certainly gone a long way in its struggle to reduce inflation from the very high levels of only a few years ago. But what remains is the last "quarter mile" which, if the experience of OECD countries during the 1980s is to serve as a guide, will continue to require the authorities' strong commitment.

In this regard, we would urge caution in wage setting. Although conceptually wage growth reflecting productivity gains should not harbor inflationary pressures, a given wage increase could become inflationary if assumed productivity gains do not materialize. Setting guidelines in line with expected inflation only should permit productivity gains to be incorporated into wages in a voluntary fashion, thus reducing the chances of excessive cost pressures. Coupled with the tax rebate scheme already adopted, such an approach would probably suffice to significantly improve the overall purchasing power of the lowest income earners.

The Mexican authorities rightly see the need to improve income distribution and to foster the real incomes of the poorest segments of the population. To this effect, increased budgetary resources devoted to the social sectors within a prudent fiscal stance, as mentioned by Mr. Marino, will probably be more efficient in alleviating poverty. Consequently, like Ms. Lissakers, we welcome the authorities' shift of resources to this end.

Concern has been expressed regarding the drop in the national saving rate--although we note the partial rebound during 1993. The cause is still being debated, but we wonder whether the apparent correlation between private savings and lower real interest payments on domestic public savings has any economic significance. If so, increased public savings brought about by lower interest bills would be compensated for by the resulting lower private saving rate. In the same vein, enterprise profits may have suffered as a result of the restructuring of many productive sectors facing increased competition. The first of these factors would point toward a permanent reduction in the overall saving rate, since real interest rates are not likely to increase over the long run. The second factor would probably indicate only a temporary blip, to be followed by a compensating rebound as the effects of enterprise restructuring take hold. Perhaps the staff or Mr. Marino could comment on these issues.

Mr. Fukui made the following statement:

I am pleased to note that the authorities have maintained a consistent and sustained effort toward macroeconomic stability, which has been pursued since the mid-1980s. Basically, these adjustment efforts brought about the recent favorable economic performance.

On the domestic side, inflation has been reduced remarkably to single-digit levels, and public finances have been maintained in surplus.

On the external front, the current account has improved. Foreign reserves have been strengthened and external debt in relation to GDP has been reduced. This is what the international community has long expected of Mexico after the debt crisis. Unfortunately, however, there was a sharp drop in economic growth in 1993 compared with the relatively modest economic growth during the period of economic adjustment. In a sense, this is quite interesting in that a strong and continuous adjustment effort, resulting in a clear declining trend of inflation, may not necessarily produce strong economic growth.

Both real consumption and investment showed a significant negative performance. The question of whether this sudden drop in consumption and investment will be short-lived gives cause for concern. As stated in the paper, if this drop can be attributed to structural change in the manufacturing sector, there is every reason to believe that consumption and investment may take some time to resume. But at the same time, the decline may also be interpreted to mean that the economy is eventually responding to the drastic change in the economic environment associated with the rapid progress of liberalization. If this is the case, the slow growth in 1993 may have laid the groundwork for sustainable, stronger growth in coming years. At the moment we cannot be sure about this point, but there are some positive indicators.

According to the outlook for 1994, exports are projected to increase by 12.5 percent, and imports, especially capital and intermediate goods, are estimated to increase by about 12 percent, suggesting the possibility of a recovery of domestic investment. In particular, the fact that a significant component of imports consists of investment-related goods is encouraging. In this regard, I agree with Mr. Marino's statement that "it has become clearer that the supply of exports is promoted by allowing imports of capital and intermediate goods at international prices." This is precisely what is happening in East Asia and is supporting strong growth in the region. Obviously, labor productivity in the export sector has increased markedly.

In any case, it is clear and encouraging that economic progress has been achieved, and it is expected that the authorities will make further efforts toward economic liberalization and modernization, thereby proving that the unsatisfactory growth in 1993 does not mean anything like "adjustment fatigue."

Another important point of policy discussion is the pressing and increasing need for social stability, and I agree with Ms. Lissakers that this is important from both a political and an economic point of view. At the present juncture, when the long and strenuous adjustment effort is about to result in gains in income for the population, social unrest is extremely costly to the smooth transformation of the economy. From this standpoint, we agree that necessary budgetary expenditures should be ensured. We welcome, therefore, the fact that expenditure for social programs is budgeted to increase in 1994. In any case, high priority should also be given to the development of a social safety net to alleviate poverty, and careful attention should be paid to wage differentials and income distribution.

I agree with the main thrust of the staff appraisal. With regard to fiscal policy, I support the authorities' intention to keep the budget more or less balanced in 1994, rather than hastily trying to move it into surplus, for the reason I mentioned earlier and also because of the slow economic growth and relatively high unemployment in 1993. Apart from the overall balance of the budget, we should also look at the components of the budget to ensure that budget expenditure is properly oriented toward supporting economic development, particularly toward building economic infrastructure. The summary account of general government expenditure is somewhat disappointing. The percentage of capital expenditure is relatively small and seems to be on a declining trend, although recent figures are not available. Actually, capital expenditure is smaller than interest payments. Here, the burden of past debt is obvious, but as interest payments decline as projected within the limited scope of the budget, clearer prioritization will be required to accommodate the strong need to build economic as well as social infrastructure.

On the revenue side, I welcome the authorities' intention to consolidate tax reform and extend it to the informal sector through improvement of tax administration and the updating of property valuations.

With respect to monetary policy, no effort should be spared to cut back inflation. Inflation, for the first time, has fallen to single-digit levels, and this trend needs to be firmly maintained. Since there is limited room in fiscal policy, it is inevitable that monetary policy must take up a heavier burden for this task. In particular, the question of how to cope with continued capital inflows is a sensitive issue, and partial sterilization is inevitable. The authorities need to monitor closely movements in the monetary aggregate from capital inflows, and additional measures on the monetary side should be taken as needed. The approval of the constitutional amendment granting autonomy to the Bank of Mexico is welcome in this context.

On external policy, exports' favorable performance is projected to continue during 1994. It is amazing that in such a developing and rather emerging economy, the export sector survived the fairly strong appreciation of the currency. It may be true that the impact of the appreciation was compensated for by the enhancement of labor productivity. The staff stated that these productivity gains were mainly attributable to structural reform and wage restraints. This is probably true and is a bright spot in the relatively modest economic performance of Mexico. It is therefore necessary to further strengthen this tendency, and for that purpose a prudent incomes policy is essential. In this regard, I welcome the wage guidelines for 1994 that emphasize the linkage between wage increases and productivity, as well as the steps to reform the labor law to facilitate labor mobility.

But at the same time, I would like to emphasize the importance of foreign direct investment. In view of the relatively low saving rate in Mexico, as discussed by Mr. Smee, foreign savings need to be fully and adequately exploited. Technological transfers accompanied by foreign investment are also effective in increasing productivity. Constant capital inflows, a significant portion of which possibly consists of direct investment, indicates the attractiveness of the Mexican economy at the moment. Continuous prudent macroeconomic policy is, of course, the key factor in maintaining this attractiveness. But we also expect more aggressive measures will be taken to establish the institutional framework to invite further foreign direct investment into the Mexican economy. Ratification by Congress of a new foreign investment law is welcome in this regard.

Finally, on trade, we agree that irrevocable steps have been taken toward liberalization of the economy through NAFTA. But the overall effect of NAFTA, which has both negative and positive aspects, is yet to be seen, and it will take more time to make an assessment. But we recognize that trade restrictions will be diminished in due course by free trade agreements such as NAFTA and other agreements with Latin American countries. While we understand the positive aspect of a freer trade zone in the region, we hope the agreements will not raise barriers to those countries outside the region.

Mr. Sirat made the following statement:

Over the past years, Mexico has achieved great success with regard to structural reforms--through privatization of many public firms and comprehensive trade liberalization--and inflation, with price increases below 10 percent in 1993 for the first time since 1972.

The medium-term outlook also appears to be rosy thanks to the past diversification of exports, the availability of a cheap and qualified labor force, and the enhanced credibility of Mexico's economic strategy resulting from the implementation of NAFTA. From this point of view, the medium-term scenario included in the staff report (Table 10) looks both reasonable and satisfactory, with inflation stabilizing at 4.5 percent a year and current account deficits stabilizing in nominal terms at about US$22 billion.

But, clearly, the short-term picture is more difficult, most notably because growth has known a major slowdown since 1992. This situation leads to two twin risks. First, there is a risk of adjustment fatigue, as exemplified by the recent social difficulties. This situation could create both short-term problems, as 1994 will be an electoral year, and more structural long-term issues, as this situation might put in question the social pact, renewed last October and of such key importance for the stabilization of inflationary expectations, and perhaps also for social stability, in Mexico. The second risk is the loss of credibility, which could lead to a sizable diminishing of capital inflows which, obviously, play a major role in the overall economic strategy as they finance the very large current account deficit.

This sluggishness of growth takes place in a context where the policy mix is extremely constrained by the balance of payments disequilibrium. Here, I believe that we have an illustration of the fact that "the current account still matters" not so much because it would prove to be unsustainable--and I would support Mr. Marino's views, given the fact that in Mexico's case, the current account deficit seems virtuous, but because it limits the room for maneuver of the policy mix. I might add that NAFTA's overall impact on the present balance of payments disequilibrium remains uncertain, but it might lead to a deepening of the current account deficit and, it is hoped, to a rise in foreign direct investment.

At the present juncture, I would recommend only a minimum change to the current policy mix, leaving time in 1994 to see whether Mexico benefits, first, from the acceleration of growth in the United States, and second, from the removal of negative expectations that occurred at the end of 1993 before the effective approval of NAFTA by the U.S. Congress.

On fiscal policy, the authorities' target for 1994 is an overall balance in the operations of the public sector. I tend to agree that this objective is appropriate, given in particular the recent rise in private savings after the 1992 shortfall. This objective might in fact be difficult to achieve in a context where pressures for a budget deficit aimed at fostering growth might increase during this electoral year, particularly in conjunction with the need for large investments and transfers in the agricultural sector. In addition, the end of the privatization process and of the decrease in interest rates in dollars would make the reduction in interest payments more difficult.

With regard to monetary policy, since 1992 nominal short-term rates have been progressively reduced without any major impact on the exchange rate of the peso. This is a clear illustration of the decrease in the risk premium on the peso. I understand that the authorities expect this risk premium to continue to decrease in 1994. But it should be kept in mind that the large stock of existing short-term bonds owned by foreign investors limits the room for maneuver as regards any further diminishing of the nominal short-term rates.

In addition, I would suggest that the structural problem here is not so much monetary policy as such but rather the intermediation by the banking system which penalizes small enterprises with no access to the Eurodollar market, because rates on domestic credits are extremely high at 27 percent. In this context, a strengthening of the competition within the banking system would certainly be warranted and, from this point of view, I welcome the upcoming creation of new banks in Mexico. Besides, I note that both NAFTA and the GATT would facilitate the implementation of foreign banks, enhancing competition in the domestic financial system. The development of the existing scheme of set-aside credits to small enterprises might be worth considering. In addition, and in the short run, some heterodox minds might suggest the creation of a collateralization scheme for such credits so as to limit the associated risk premium. Naturally, such a development would make more difficult the effective implementation of the indirect monetary policy. But this is a risk that might be worth taking, particularly given the fact that inflation appears likely to be linked more to structural rigidities in the nontradable sector than to an overall inadequate monetary policy. Perhaps Mr. Marino or the staff could comment on this issue.

As to exchange rate policy, in the short run, for similar reasons--namely, the fact that the consumer price index does not differentiate between inflation in nontradable goods and inflation in tradable goods, which have been rather different over the past years--I wonder whether the effective exchange rate, shown in Chart 6 of the staff report, is a good measurement of the competitiveness of the Mexican economy. The large rise in exports since 1989 and the increasing diversification of the economy would lead one to believe the contrary. The Mexican authorities would have some room for maneuver as regards the evolution of their nominal exchange rate within their semi-crawling-peg system. The question is whether they should use it with a risk of losing a part of their gains as regards the risk premium on their short-term rates.

I would suggest that it is too early to assess whether there is a clear overvaluation of the peso. In any case, a mere measurement of the rise in exports might not be a precise enough indicator, as illustrated by the fact that the issue of a possible overvaluation is still discussed, including by this Board, despite a relative strong export performance. Now that the uncertainties surrounding NAFTA have been cleared up, I suggest that a good indicator of any overvaluation of the peso would be capital account developments and, more precisely, the pace of development of foreign direct investments which should, all things being equal, greatly benefit from the implementation of NAFTA. In this perspective, the ratification of a new foreign investment law, mentioned by Mr. Marino, is welcome as it would expand the scope for foreign investment in Mexico. If, at the end of 1994 or in 1995, it appears that in effect foreign direct investment did not rise significantly, then the question of any overvaluation of the peso could be raised.

In conclusion, I commend the authorities for the will with which they have implemented over the past six years this courageous and intelligent adjustment program. This year, 1994, will be difficult. At some point or other, the authorities will have to balance their growth and inflation objectives. The risk of slippages will not be negligible. But given the past track record of the Mexican authorities, I am confident that Mexico will stay on the right path toward higher sustainable growth.

Mr. Zhang made the following statement.

Mexico's remarkable economic performance during past years, which deserves high praise, can be attributed to the authorities' energetic efforts to secure a tight macroeconomic stance, embark on profound structural reforms, and open up the economy. The achievements made on many fronts so far, as described by Mr. Marino and highlighted by previous speakers, are very striking. Apart from what has been achieved, the authorities have not relaxed their efforts to reform and adjust the economy and thus expedite its integration into the world economy. Inter alia, I commend the authorities' determination to meet increasing challenges by boldly implementing NAFTA.

One of the authorities' impressive achievements is their firm commitment to the pursuit of a restrained fiscal stance, which has resulted in substantially strengthening public finances and maintaining a commendable fiscal surplus. We encourage the Mexican authorities to persevere with these consolidation gains. It seems to me that the current surplus needs to be maintained until domestic savings can be strengthened. This concern is also expressed by Mr. Havrylyshyn. Therefore, we are concerned about the intended shift of the public sector surplus to a deficit, which may not be conducive to the reduction of interest rates and consistent with continuously curbing inflation.

On monetary policy, I can sympathize with the authorities' intention to slightly cut real interest rates, reflecting increased confidence in the domestic economy stemming from the regional trade agreement and further integrated financial markets. This policy is expected to boost domestic investment, thus fostering the sluggish growth to which monetary policy could make a positive contribution. However, its potential side-effects on capital inflows and inflation cannot be ignored. In this respect, we are pleased that the authorities will remain vigilant by continuing to maintain a restrained credit stance.

Like other regional developing countries, Mexico's monetary policy has traditionally hinged upon external development prominently characterized by significant capital inflows. Meanwhile, reining in inflation is also expected through a tightened monetary policy. For Mexico, in view of the need to absorb the excess liquidity from short-term capital inflows and to strictly contain inflation, some sterilization action seems to be required especially in the face of the forthcoming effects of the entry into NAFTA, which may be expected to pour exceptional capital into Mexico in the near future. In this regard, we agree with the staff that the authorities' policy responses have been supported by fiscal surpluses and have sped up the privatization process. It is evident that the experience of countries in this region shows that only after successfully achieving a sustainable fiscal position can hyperinflation be brought down. We commend the authorities for their admirable achievement in this regard.

In addition, we would emphasize the importance and urgency of strengthening the regulation and supervision of domestic financial markets, because the efficiency and ability of the domestic banking system to intermediate excess liquidity could avoid systemic risks associated with capital inflows.

Exchange rate policy, in conjunction with a tight financial policy, has aimed at discouraging speculative capital inflows, facilitating a reduction of the inflation rate, and maintaining external competitiveness. It is impressive that persevering with a flexible and responsive exchange mechanism has continuously served the above objectives quite well so far.

Needless to say, the current situation complicates the conduct of exchange rate policy in terms of how to assess the appropriateness of the underlying policy. The facts are, first, inflation has come down to single-digit levels, albeit somewhat higher than that of Mexico's trading partners; second, capital inflows are expected to continue, with net inflows being more than sufficient to finance the current account deficit and to contribute to an increase in international reserves; third, the peso is estimated to have appreciated by 8 percent in real effective terms during the past year, continuously eroding competitiveness.

Therefore, if the market requires, will the authorities consider depreciating the currency by up to 12 percent in nominal terms by the end of 1994 to secure the relative stability of the exchange rate? However, we are more concerned about the possible real appreciation of the peso in 1994; I am not sure what the authorities would allow without impeding export growth. The staff's comments on this issue would be appreciated.

I am impressed by the marked improvement in Mexico's balance of payments, and it is pleasing to observe that its vulnerability to adverse external changes has lessened. One of the most remarkable achievements is the authorities' determined opening up of its economy to external competition by putting NAFTA into effect, although Mexico faces unprecedented risks and formidable challenges ahead.

In this connection, although I am aware that the consultation took place prior to the formal implementation of NAFTA, like previous speakers we consider it very important that the staff report should incorporate the Agreement's immediate and medium-term consequences, either statistically or dynamically, for the Mexican internal and external sectors in 1994, and even more generally for the region as a whole. We would be interested in the staff's assessment of this issue. We encourage the staff to initiate a sensitivity analysis on this issue, which I hope could come in the form of a research paper and could be addressed thoroughly in next year's consultation.

In conclusion, we are pleased with the Mexican macroeconomic policy strategy, and the authorities should be proud of their success in economic adjustment. Looking ahead, numerous challenges come with these exceptional opportunities.

Mr. Evans made the following statement:

One year after the successful completion of their extended arrangement, the Mexican authorities have continued to demonstrate the highly commendable commitment to a stable, liberalized, and deregulated economy that has won them the respect of so many international observers. The continuing downward trend of inflation, the strong recovery of exports, the retention of a surplus in the public finances, the granting of autonomy to the Bank of Mexico, and, of course, the successful ratification of NAFTA are all noteworthy. I am assured that policy remains on the right track, and I welcome the authorities' intention to preserve their current stance.

Nevertheless, we have still to see the economy respond vigorously to the reform process. Here I share some of the concerns expressed by earlier speakers. This is an economy with a population growth of about 2 percent, which has seen some excellent and far-reaching structural reforms and trade liberalization measures. But productivity growth has been rather slow: World Bank figures suggest no more than 1/2 of 1 percent a year total factor productivity growth. Returns to investment appear poor. As Mr. Havrylyshyn has pointed out, the Mexican country weighting seems not to have improved very much in the past six years. Growth has been modest, at under 3 percent a year, or about 1 percent per capita. Projections for inflation and growth this year would, if realized, be a good outcome and should lead on to faster growth in later years. However, I wonder whether this might not be a rather optimistic combination, as the paper appears to hint.

I share some of the concerns already expressed on external and competitiveness issues. Private capital inflows are often a sign of strength in the economy, as is the current account deficit associated with it. The Lawson thesis, to which Mr. Smee has referred, was that a private sector deficit would have a strong tendency to correct itself, within the context of macroeconomic policies aimed at stabilization and properly functioning markets. The key question is therefore what further role public policy should play.

For the future, there are questions over both the sustainability and the nature of capital inflows. I note that the proportion of inflows attributable to foreign direct investment has actually declined, which may be connected to the somewhat disappointing outcome on productivity and profitability. Meanwhile, looking at the prospects for the next year or two, while the authorities may be hoping that nominal interest rates in Mexico will come down, U.S. rates may be going up. I note the already high level of interest rates and the level of competitiveness shown in Chart 6. In these circumstances, what should be the response of the Mexican authorities if capital inflows are much less than posited or, for example, if the trade deficit is worse than expected. I would be interested in comments from the staff and Mr. Marino. In my view, a real degree of flexibility in exchange rate policy is needed, and I believe this can be consistent with getting inflation down.

I agree with Mr. Smee about the need for a much greater role for market determination in the field of wages and prices. I share his skepticism about the longer-term effects of wage and price pacts. In my view, these can often be counterproductive in terms of creating labor-market rigidities. I agree with Ms. Lissakers that further information would be useful from the staff on capacity utilization, the output gap, unemployment and, most of all, on the staff view of the long-term sustainable growth rate of the Mexican economy.

Turning to the fiscal questions, I agree with the staff suggestion that, in attempting to tackle the still low level of savings in the economy, it is not possible to rule out further resort to public sector saving. I accept that the rebound in confidence that we hope to see this year, together with the gradual process of adjustment to firm public finances and financial sector liberalization, gives us some comfort that the increase in private sector saving last year was not simply a one-off phenomenon. But sustaining this rising trend will not be quick or easy, and this reinforces the desirability of a cautious fiscal stance.

As for structural policies, given the importance of the savings issue, I wonder whether there is more to be said about possible institutional measures to encourage saving? I was encouraged by the reference to the proposed privatization of the Social Security Institute pension scheme. Progress in encouraging the development of private pension funds, whose benefits are very evident in countries like Chile, has so far been fairly cautious. I understand that employers still pay only 2 percent of employees' salaries into such private funds, compared with 10 percent in Chile. Perhaps the staff or Mr. Marino could expand on the authorities' plans to set the agenda for the period following the election.

In addition, it would be worth exploring how far structural obstacles played a role in explaining why growth never really took off over the past six years. Recent reports of World Bank work suggest that there is still some way to go in creating the right legal, regulatory, and labor market environment conducive to private sector growth. I would welcome staff comment on these issues.

In conclusion, and despite some cautionary comments, I would like to reiterate my support and admiration for the authorities efforts.

Mr. Lanciotti made the following statement:

I add my voice to those commending the Mexican authorities for the continuing successes in implementing well-designed economic adjustment strategy. I agree with the thrust of the staff's appraisal, and I will make only two observations.

First, the recent deceleration in real GDP growth was mainly the result of the economy's restructuring. The efforts to reduce the rate of inflation must have played only a minor part in containing growth, because it is precisely these efforts that generated investment by re-establishing confidence in the economy's potential. I am not sure, therefore, whether some relaxation of fiscal policy was the appropriate means to address the cyclical downturn.

The staff notes that "an actively stronger growth and the sizable reduction of inflation that is sought may be difficult." The report correctly cautions that, with no sterilization from the fiscal side in 1994, interest rates would be affected. I also note from the staff report that the private saving rate, despite its recent recovery, is projected through 1998 to remain considerably lower than the saving rate of the late 1980s. I share the views of Mr. Evans on the role of structural aspects in this respect.

Second, on exchange rate policy, two main considerations were behind the authorities' decision to widen the exchange rate band in October 1992: the increased flexibility of the exchange rate that would result would push capital inflows beyond the short-term and would deter speculative movements; and a signal would be sent to the markets that there would be more room for orderly exchange rate management. I am not clear whether these concerns remain valid at the present juncture. Furthermore, because the authorities intend to continue to adjust the upper end of the band in a way that would allow room for a nominal depreciation of up to 12 percent in the course of 1994, I am not sure how to read between the lines of the report encouraging the authorities to stand ready "to take measures as necessary to ensure export competitiveness."

While it can hardly be disputed that any substantial further appreciation would pose certain risks, the appropriate way to contain such risks would be by achieving the targeted reduction in inflation and by adhering to the wage guidelines. It is most encouraging to observe from the report and from Mr. Marino's statement that there continues to be a strong policy commitment to achieve these targets and to continue with sound domestic financial policies in the long term.

In my opinion, Mexico has now reached a more permanent state in which public finances are under control, export performance is good, and inflation has approached a rate where the differential vis-à-vis the United States could hardly be regarded as inappropriate for a rapidly growing economy with rising relative prices of nontradable services. In other words, the conditions seem to be in place now for a successful hardening of the exchange rate commitment. I wonder whether, under the present circumstances, keeping the band rather wide has any advantages, or to what extent this might signal to the markets a possible reorientation in the future toward somewhat less stable parity as the medium-term goal.

Looking at last year's experience, nominal interest rates declined steadily after the first quarter of 1993. The only exception was the one-week jump prior to the U.S. congressional vote on NAFTA. A good question is whether the jump would have been any greater, under a narrower exchange rate band, or whether it would take any longer to return to normal after the positive vote.

I realize that the answer may not be easy. In general, however, one could expect that, in an environment free of trade restrictions and capital controls, and with foreign borrowing that is not the result of unbalanced public finances, a narrower exchange rate band would reduce rather than increase financial uncertainty and speculative flows. Also, given the demonstrated flexibility of Mexican labor markets and the continuing good prospects for rapid productivity growth, the correction that would be needed as a response to a possible overshooting of domestic prices and wages would not be high. To summarize, a narrower band would add support to the effort of keeping domestic inflation more in line with that in the major trading partner.

The staff representative from the Western Hemisphere Department commented that the staff and the Mexican authorities were concerned about the deceleration in economic activity. The precise reasons for the deceleration and the weight to be given to various factors were not clear, but obviously the slowdown was related to the restructuring process under way, which had resulted in several manufacturing enterprises going out of business. That situation had been exacerbated by the real appreciation of the peso. Also, the uncertainties related to NAFTA had had a serious impact in 1993; anecdotal evidence indicated that several enterprises had postponed projects that were to have come on stream in 1993. In addition, Mexico's attempts to reduce inflation from close to 160 percent at the end of 1987 to single digits had undoubtedly contributed to the deceleration in economic growth.

The decline in private savings was presumably related to the temporary consumption boom following the liberalization of the external trade and financial system, the staff representative continued. That development was similar to the experience of many countries in Latin America. The authorities believed that the savings performance had shown improvement in 1993 because the consumption boom had begun to wind down. Anecdotal evidence also indicated that, because of the increase in unemployment and related general uncertainty, consumers had decided to save more, offsetting in part the reduction in saving expected from the decline in income. The staff's medium-term projections assumed, quite conservatively, that the saving rate would not return to the level of the late 1980s or early 1990s.

On export competitiveness, the appreciation of the real exchange rate over the past few years had nearly eroded the real depreciation that had taken place up to 1987, the staff representative explained. Export performance suggested that the exchange rate was not out of line, but the authorities would need to keep it under close review.

On the question as to whether the widening of the exchange rate band was needed, the experience of November 1993 was illustrative, the staff representative added. Prior to the U.S. congressional vote on NAFTA, nervousness had developed in the market, and the authorities were able to let the exchange rate reach the top of the band, to MexN$3.25. The authorities did not believe that widening the exchange rate band gave the wrong signal for exchange rate policy. Investors were aware of the narrower band, which testified to the Government's commitment to exchange rate stability, but the authorities believed that the wider band was necessary to deal with aberrations such as had occurred in November 1993.

Data on the real effective exchange rate based on unit labor costs, which took into account changes in productivity, pointed to some real appreciation of the exchange rate, the staff representative said. However, data on average productivity could be misleading because it encompassed the changes over the whole spectrum of the manufacturing industry. With the restructuring in Mexico, some industries had adapted rapidly to the opening up of the economy and had introduced new plant and equipment, leading to a strong expansion in manufacturing exports; industries that had not adapted were going out of business. Therefore, it was difficult to interpret, from global productivity indicators, developments in the manufacturing industry, but there was reason to believe that labor productivity in export manufacturing had increased significantly.

To some extent, the high incremental capital/output ratio was related to the changing structure of the economy, the staff representative commented. A large part of new investment was actually replacement investment and did not add to the capital stock.

Regarding the question about the impact of U.S. interest rates on the balance of payments, as indicated in the alternative medium-term scenarios, following the sharp decline in external indebtedness to about 30 percent of GDP, an increase of, say, 2 percentage points in U.S. interest rates over the base scenario would result in an increase in interest payments of about US$5 billion, the staff representative observed. As to the effect on portfolio investment, the authorities' commitment to continue providing incentives for private capital inflows would ensure that domestic interest rates would take into consideration interest rate developments in the United States.

There were a number of employment indicators in Mexico; the most restricted definition, open unemployment, showed an increase in unemployment from about 2.2 percent to about 3.5 percent between 1992 and 1993, the staff representative noted. The broadest definition, which also included persons who had worked for less than 35 hours a week, indicated an unemployment rate of 20-23 percent in 1993. In light of those wide variations, the staff had simply referred to the increase in unemployment without citing specific levels.

The possible risk that could accrue to the banking system as a result of its foreign borrowing was a cause of concern, the staff representative remarked. Following a large increase in foreign borrowing in 1991, the authorities had implemented measures in 1992 to restrict foreign borrowing by banks to a limit of 10 percent of total bank liabilities. The resulting sharp cutback in their foreign borrowing had caused some liquidity squeeze for the banks and the limit had been eased somewhat toward the end of 1992 to 20 percent, on condition that about one half of the increase be devoted to loans to export industries or industries importing capital equipment. Subsequently, foreign borrowing by the commercial banks had increased in line with those regulations, but the authorities would monitor the situation closely.

As to whether special mechanisms were needed to direct credit to small enterprises, the staff representative recalled that in 1992, in light of the difficulties faced by the commercial banks, credit to small and medium-sized enterprises from the development banks had been expanded on the basis of foreign borrowing. It was important to note that the loans had been effected through the commercial banks at rates that covered the cost of funds, including for the exchange rate risk. The authorities were committed to ensuring that credit was available to small and medium-sized enterprises, but they stood firm on limiting the extent of any subsidization of those credits.

The social pacts had played an important role in the progress seen in the Mexican economy over the past few years, the staff representative observed. When the pacts had been first introduced in 1987, they had been credited with changing the inflationary psychology by facilitating a move from a backward-looking indexed system to a forward-looking system. However, over the years, the scope of the pacts had changed; they no longer focused entirely on limiting price or wage increases but allowed ample room for the negotiation of wage contracts. In 1994, they encouraged discussion between unions and employers on wage increases in line with productivity increases. Basically, the pacts were useful because they involved all the main players in the economy and helped to bolster confidence in government economic policy while allowing for the market mechanism. Obviously, there was some question as to how long the pacts could be sustained; perhaps when the inflation rate reached international levels, the authorities would need to examine whether the pacts were still required.

The legal framework, specifically that related to labor reform, warranted review by the authorities, the staff representative remarked. Present regulations made it somewhat difficult for firms to lay off employees and, generally, to increase labor flexibility. At present, promotion was based on seniority, and the settling of labor disputes could entail long delays and legal entanglements. When the Government had proposed legislation to deal with the issue in 1992, it had met with opposition from the labor unions. Accordingly, the authorities had decided to follow an approach based on consultation with the labor unions rather than through legislation. Also, labor legislation could be complicated to the extent that it might require unemployment insurance, which had implications for the budget.

Mexico's credit rating had improved significantly over the past few years, the staff representative stated. The country had been successful in tapping new markets and had recently raised bond issues in the German and Japanese markets.

Public sector investment had been a casualty of the stabilization effort, although the statistics should be interpreted with care because, with the changing structure of the economy, many activities--for example, road building--had been shifted from the public sector to the private sector, the staff representative said.

If capital inflows were smaller than anticipated, the Government would no doubt show the same pragmatism and flexibility in its economic policy that it had exhibited in November 1993, the staff representative from the Western Hemisphere Department stated. The retirement savings scheme introduced in 1992 had succeeded in mobilizing US$16 billion--a significant amount--but it was not clear whether those resources represented additional savings or simply a substitution of one kind of savings for another. The authorities, however, were committed to a macroeconomic framework that was conducive to increased savings. Privatization of the social security system was one possibility being examined, but the authorities recognized that some kind of government scheme would have to be retained to deal with the lower-income brackets.

Mr. Sirat commented that he had mentioned the collateralization, or guarantee, of credits to small enterprises in view of a possible link between the current sluggishness in growth and the intermediation costs for small enterprises. He wondered about the short-term impact of enhanced competition within the financial system, notably in terms of new foreign banks in the banking system, for instance, with regard to reducing intermediation costs sufficiently to help finance small enterprises.

The staff representative from the Western Hemisphere Department reported that the authorities hoped that the opening up of the banking system would reduce intermediation margins, currently about 9 percentage points on average but which ranged from about 5 percentage points over deposit rates for prime borrowers to 10-15 percentage points for others. In Mexico, three banks accounted for 60 percent of the total assets of the banking system. The authorities hoped that the entry of new banks--perhaps as many as 20--would increase competition, add diversity to the financial system, and help to reduce the high intermediation costs.

Ms. Lissakers asked, in light of recent events in Mexico and the upcoming election, about the impact of a possible large fiscal swing, say, to a deficit of 1 percent of GDP.

The staff representative from the Western Hemisphere Department stated that the authorities had recently reaffirmed their commitment to fiscal balance. They had left open the possibility of some reallocation of expenditure toward the agricultural sector and social spending, with some recalendarization. Of course, in an election year, there were likely to be pressures for expenditures, and thus there was the possibility of a fiscal deficit. In that case, the authorities would be forced to make other policy adjustments in order to attain their objectives.

Mr. Marino noted that the question raised by Ms. Lissakers was important in light of recent events in Mexico. There was, quite rightly, some concern that populists would demand a change in strategy and perhaps even in the economic model. However, he assured the Board that the Government was committed to staying the course. The President had reminded the population of the adverse effects of the populist policies of the 1970s and early 1980s. Many of those effects were still felt in Mexico: the policies had often created greater problems than those that they had been intended to solve. Therefore, a return to those policies would not take place.

The Government was committed to price stability, and clearly, within the framework of a balanced budget, the Government intended to promote economic recovery, boost production and employment, and strengthen its social policy, Mr. Marino stated. In that connection, the aim was to consolidate the current strategy: to improve the quality of education and to develop the solidarity program, which, with little bureaucracy, addressed the needs of the poorer segments of the population. The authorities wanted to target social spending and increase the participation of local communities in setting priorities and decentralizing spending. For the first time in Mexico's history, more than half of the budget--amounting to over 10 percent of GDP--was channeled toward social spending in 1994, but still within the framework of a balanced budget. The Government did not wish to dissipate all the efforts of the first five years of the Administration.

Mr. Jiménez de Lucio made the following statement:

Like previous speakers, we commend the Mexican authorities for their success in stabilizing and modernizing the economy over the past five years. The profound changes introduced during that period, which transformed a heavily regulated and protected economy into an open and efficient one, have now been further consolidated with the ratification of NAFTA. A sound macroeconomic base for sustained growth is solidly in place, and future development prospects are bright. Mexico rightly deserves to be considered a model case of successful economic adjustment.

At the same time, recent events highlight the importance of addressing directly the most urgent social needs of the population so as to ensure the necessary political support for adjustment programs. Social safety nets should be an integral part of all adjustment programs, with their design carefully evaluated and their implementation closely monitored. In this regard, an analysis of the programs undertaken to this effect by various countries, such as PRONASOL in Mexico, could provide valuable policy lessons and should be assigned high priority.

We are in broad agreement with the staff appraisal and will therefore focus our comments on two issues: microeconomic adjustment and exchange rate policy. In our view, the main challenge facing Mexico in the short term is to deal with the microeconomic consequences of its macroeconomic adjustment. More specifically, small and medium-sized enterprises need to adapt to the new, more competitive environment. These enterprises account for the bulk of employment; therefore, the speed and smoothness with which their transition occurs has a direct bearing on the pace and strength of overall economic growth.

The increased competition resulting from the implementation of NAFTA, as well as the prevailing inflation differential between Mexico and its main trading partner, makes the competitiveness of small and medium-sized enterprises an issue of paramount importance. These enterprises are particularly sensitive to the continuing real appreciation of the peso, as they tend to experience the offsetting productivity gains associated with structural reforms later, and to a lesser extent, than larger enterprises.

Exchange rate policy is complicated by the large and continuing capital inflows which exert upward pressure on the peso. Moreover, the authorities' efforts to sterilize these flows through open market operations push interest rates higher, thus providing an additional incentive for the flows to continue. On the positive side, now that NAFTA has been ratified, it is likely that capital inflows will increasingly come in the form of direct investment, thereby eventually leading to higher output and exports.

We believe that the key element for addressing the problems generated by both the real exchange rate appreciation and large capital inflows is the further lowering of inflation and inflationary expectations. The present system of daily adjustment of the exchange rate and sterilization of capital inflows seems to be setting a floor on inflation and exerting upward pressure on real interest rates. In a context of balance on the fiscal accounts and a deepening of structural reforms, a narrowing of the exchange rate band would seem appropriate. Under present circumstances, an acceleration of the devaluation rate, as some speakers have suggested, would be counterproductive. It would generate inflationary pressures and could imperil the social pact underpinning the adjustment effort. We are heartened by Mr. Marino's assertion that a low single-digit inflation rate and a stable exchange rate remain the top priority goals for policymakers.

Mr. Prasad made the following statement:

At the time of the previous discussion on Mexico, the Board noted the wide-ranging structural reforms and the strong fiscal position that had resulted. I would agree with earlier speakers that, the slowdown notwithstanding, Mexico continues to have strong medium-term prospects, and we commend the authorities for these achievements.

I will touch on just one issue relating to recent developments regarding social spending, along the lines of earlier comments by Ms. Lissakers and others. The report carries an analysis that the percentage of people living in "extreme poverty" declined from 14.1 percent to 11.8 percent in 1992. Other reports, however, indicate that this figure rose to 16 percent in 1993. World Bank documents indicate that some 20 percent of the population still survives below a poverty line of $1 a day. With GDP growth down, investment reduced, unemployment rising, some industries reported closed, and others experiencing environment problems, how can poverty be declining?

Second, given recent developments, and as brought out in the staff papers and in Mr. Marino's comments, the authorities will continue to blend moderate growth with progress in the social area. This will advisedly be combined with adherence to stiff fiscal measures. I wonder whether some further analysis of the direction of social expenditure growth is not warranted.

While there may not be any doubt that pro-market changes will remain in the forefront, the emphasis in the short term will focus on social spending and political reform. We already have indications of this, with recent announcements regarding allocations for rural spending, as well as the scheduling of the bulk of expenditure for the earlier part of the year ahead of the elections as part of the recalendarization mentioned by the staff. Perhaps I am missing the finer nuances, but a portion of the enhanced allocations seems to be through subsidy-linked transfers, which will constitute a one-time consumption transfer rather than investment for growth. To that extent, it may not address the social correction issue.

Mr. Tetangco made the following statement:

I join other speakers in commending the Mexican authorities for the considerable progress made over recent years. The staff report attests to continued improvements made in containing public finances, reducing inflation to single-digit levels, and implementing further structural reforms. I nevertheless would like to make a few points.

The first is the fact that Mexico has achieved a significant improvement in its external debt situation through debt restructuring and improved economic performance. This has been recognized by the capital markets that have once again become a substantial source of funds for Mexico. According to the Fund's publication "Private Market Financing for Developing Countries" (December 1993), Mexico is today the leading developing country borrower, successfully borrowing increasing amounts at narrowing spreads. At the same time, foreign investments have also continued to flow into the country. While foreign financing continues to be available, and this does not seem to be an area of concern at this time as pointed out by Mr. Jaramillo, I nevertheless agree with Mr. Havrylyshyn and other speakers that domestic savings play a complementary role in financing domestic investment, as observed in a number of fast-growing economies, particularly in Southeast Asia.

The second point is that, in its adjustment effort, Mexico has correctly placed emphasis on fiscal prudence, and this is reflected in the positive overall public sector balance during the past three years. For 1994, the authorities expect the fiscal position to move from surplus to balance, in view of the low growth rate in 1993 and the continuing high unemployment rate. The sizable number of taxation changes, as well as commitments to increase social spending, particularly to aid the poorest sectors and incorporate them in the development process, would seem to make projection of the coming year's deficit more hazardous than normal, a point also made by Ms. Lissakers and others.

To achieve the authorities' fiscal target, it may be judicious to have contingency measures to meet unexpected pressures that may arise on the fiscal front. While the Mexican fiscal position remains enviable, I join other speakers in advising caution in this area and welcome Mr. Marino's assurance that this is indeed the authorities' intention.

Looking at the agricultural sector in particular, we support the move away from a price support system to the use of more transparent transfers to the farming sector. A rather lengthy 15-year time frame is envisaged for removal of these income subsidies. Successful implementation of this program would require early consideration of ways to achieve improved agricultural productivity before that time, with appropriate emphasis on investment and not just consumption. We would appreciate further information that the staff might be able to provide in this regard.

Third, the goal to further reduce inflation to 5 percent in 1994 is a challenging one, especially given the need for greater reliance on monetary policy to achieve this. As the staff points out, adherence to low wage settlements will be critical for achieving this goal, and continuing cooperation between the Government and the private sector in this regard would remain important.

Finally, the Mexican authorities have clearly demonstrated that they are not content with progress made to date, and we support their continued efforts toward further inflation reduction and structural reform.

Mr. Al-Tuwaijri made the following statement:

I congratulate the Mexican authorities on the impressive progress achieved in stabilizing and reforming the economy. Over the past five years, public finances have been strengthened, public debt has been cut, and inflation has been on a declining trend. Moreover, the substantial structural reforms already implemented have led to a more dynamic and open economy that is much more capable of sustaining noninflationary growth. However, as Mr. Marino notes, these changes have led to a temporary slowdown in 1993, but the outlook for 1994 is for a substantial pickup in growth.

I am in broad agreement with the thrust of the staff appraisal. While remarkable progress has been made in reducing inflation over the past few years, the inflation rate remains above trading partners' levels. This has led to real appreciation of the peso. Although the impact on competitiveness has been limited so far, owing in part to structural reforms, an improved inflation stance remains critical to the authorities' intention of preserving relative exchange rate stability. Thus, the twin objectives of reducing inflation further by 3 percentage points in 1994 while reinvigorating GDP growth are welcome.

A number of factors are likely to bode well for investment and growth. First, the passage of NAFTA has improved confidence in the Mexican economy and is likely to lead to a sharp rise in capital inflows and investments. Second, the increased competition in the banking sector is expected to reduce the deposit-lending spread, thus leading to increased demand for credit. Third, the restructuring of some of the major companies has been completed and is expected to start showing results in 1994. And fourth, the strengthening of the U.S. and Canadian economies would increase Mexican exports to those countries.

While these factors should facilitate the attainment of the growth objective, they are likely to increase demand pressures, thus complicating the realization of the inflation target. Moreover, additional policy efforts may be required. Any perceived hesitancy in the commitment to the inflation target carries the risk of undermining confidence, which is essential for a rebound in economic activity.

As noted by Mr. Marino, there are understandable reasons for slightly relaxing the fiscal stance in 1994. These reasons notwithstanding, the authorities should be encouraged to stand ready to strengthen their fiscal position at the first indication of increased inflationary pressures.

The authorities' cautious monetary policy, aimed at lowering inflation, continues to be appropriate. Here, a strong fiscal stance should facilitate the implementation of such policy, while reducing pressures on interest rates and lowering the incentives for short-term capital inflows. Moreover, increased independence of the central bank should enhance the credibility of monetary policy and thus work in the same direction. The improvement in bank regulations and strengthened supervision is also welcome.

These efforts will need to be supported by a flexible incomes policy and a more liberal labor market. In this regard, the new wage-price pact is an important step in the right direction.

Mrs. Wagenhoefer made the following statement:

Like other speakers, I congratulate the Mexican authorities for their successful policies in recent years. In particular, the Mexican economy continued to make progress in 1993 in nearly all fields of interest to economic analysis.

However, the unfavorable growth performance of the Mexican economy in 1993 is disappointing given the much more favorable forecasts of one year ago, of 3 percent. Given the fact that growth instead slowed significantly to an estimated 0.6 percent in 1993, I would have hoped for a somewhat broader elaboration and assessment of this development in the staff report. The staff does briefly present three explanations for this slowdown, namely, the ongoing process of transformation and the restructuring of firms in the manufacturing sector; the uncertainty about NAFTA; and the efforts to bring down inflation.

I do not have problems with the first and second argument, but I do with the third--also presented by the authorities. Given the fact that anti-inflationary policies have now been successful for a number of years, I wonder whether the relationship should not be the other way around, that is, bringing inflation down, and effectively so, does encourage growth.

I fully agree with the staff recommendation that a further lowering of inflation will be of crucial importance in 1994. A difficult question, of course, for the Mexican authorities arises: how to achieve a lower inflation rate?

Mexico will certainly benefit from further net capital inflows which are a driving force not only for future growth but also for the exchange rate. They may lead--as experienced by other successful countries in Latin America--to a real appreciation. The staff points out that further substantial real appreciation could pose certain risks. Therefore, it might seem appropriate that the Bank of Mexico should continue to intervene in the exchange markets to prevent a nominal appreciation of the peso. However, a stabilization of the nominal exchange rate by way of sterilization is at the expense of higher interest rates, thereby attracting further capital inflows. Or the stabilization of the exchange rate is at the expense of higher domestic money growth, thereby endangering the reduction of the inflation rate. Consequently, a policy aimed at reducing the inflation rate should accept a more flexible approach in terms of exchange rate policy. I wonder, in this context--like other speakers--whether the intention of the authorities to continue adjusting the upper end of the band is the optimal way.

Mr. Rouai made the following statement:

We commend the authorities for the continued progress achieved in restructuring the economy and in reducing financial imbalances. We note, in this respect, the inclusion of Mexico in the operational budget of the Fund, which reflects the viable and strong balance of payments position achieved by the country.

In his statement, Mr. Marino traces the slowdown in economic activity to the uncertainties derived from the process of ratification of NAFTA, the rigidities in inflationary expectations, and a more cautious credit policy by commercial banks in light of the deterioration of their loan portfolios. We would like to comment briefly on this latter point, in particular on the Mexican experience in the area of financial reform described in Appendix II of SM/94/41.

The paper shows that the sequencing of the financial reform program emphasized deregulation and privatization, at a time when the macroeconomic environment was unstable, and without paying due attention from the beginning to improving banking supervision and prudential regulations. As the staff pointed out, "at the time *the privatization of the banks was completed (mid-1992), the* regulatory framework suffered from several deficiencies" and the quality of loan portfolios deteriorated, which contributed to the persistence of high interest rates and wide intermediation margins. During the same period, commercial banks' external debt increased from $8 billion in 1988 to $22 billion in 1993. Since 1992, the authorities have reacted by introducing additional reforms to improve banking supervision and the regulatory framework and enhance competition among banks.

This experience suggests that to ensure a better chance of success for any financial sector reform, consolidation of banking regulations and the supervisory policies should precede deregulation. In addition, it is important to stabilize the economy before initiating far-reaching financial deregulation. We would welcome any elaboration from the staff with regard to this sequencing.

Mr. Koissy made the following statement:

In recent years, the Mexican authorities have demonstrated a strong commitment and consistency in their adjustment efforts, showing, when necessary, flexibility and pragmatism in the implementation of the requisite policies. Mexico is now reaping the benefits of these efforts as evidenced by the continued decline in the rate of inflation, the strengthening of the balance of payments, and the emerging surpluses in the budgetary position. Moreover, with the implementation of far-reaching reforms, the economy has become more responsive to market forces.

Unfortunately, Mexico's good record of strong adjustment with growth was threatened in 1993 by declining oil prices, by a temporary output loss owing to the effects of the modernization process in the industrial sector and the efforts to curb inflation, and by uncertainties created by discussions on NAFTA ratification. The timely corrective actions taken by the authorities to deal with these factors have been instrumental in preparing the Mexican economy for strong noninflationary growth in 1994 which will allow the authorities to continue to make progress in their objective of extending the benefits of economic growth to a broad segment of the population. I am in broad agreement with the staff appraisal and I support most of the comments made by previous speakers.

With regard to inflation, it is encouraging to note the authorities' determination to further reduce the inflation rate from 8 percent in 1993 to 5 percent in 1994. Notwithstanding the impressive deceleration in prices registered in recent years, there is a risk that the significant growth of output expected this year may rekindle inflationary pressures in the economy. It is therefore advisable that the Mexican authorities be prepared to counteract with appropriate measures, should signs of an acceleration in inflation emerge.

As to fiscal policy, the Mexican authorities are well aware that recurring fiscal surpluses while the economy's growth is still slow, coupled with a high level of unemployment, cannot continue. However, they are cognizant that fiscal restraint should continue to be a key element of macroeconomic management. In fact, a fiscal deficit in the case of Mexico would likely put unnecessary pressure on monetary policy to help ease inflation, and we agree with the authorities who are seeking an overall balance in the operations of the public sector. To this end, the tax-reduction package being introduced by the Government is appropriate.

Mexico's performance in recent years is commendable in many respects and has paved the way for sustainable growth in the medium term. The external sector has played an exceptional role in this performance as evidenced by strong exports of manufactured goods which contributed to strengthening the external current account position. With the approval of NAFTA, the external sector will have an even greater role to play. However, the continued real appreciation of the peso may erode the external competitiveness of the Mexican economy and I would encourage the authorities to keep exchange rate developments under close review and stand ready to take necessary measures so as to safeguard Mexico's competitiveness. Achieving the inflation target and ensuring that the wage guidelines are respected in 1994 are important steps that will help to reach this objective.

Mr. Cserés made the following statement:

Like other speakers, we are impressed by the continued reform efforts of the Mexican authorities and by Mexico's 1993 performance. Mexico's achievements since launching the extended arrangement, listed by Mr. Marino, are striking, particularly in the face of the numerous challenges that Mexico has had to face in recent years.

Despite these favorable results, Mexico still has some problems, and the authorities' efforts to gradually revitalize the economy must defer to still more urgent priorities: precedence must go, in the short term, to the fight against inflation, and in the medium term, to strengthening the economy's resistance to adverse external shocks, such as the changing oil prices of the past two decides or the flight of capital that preceded the approval of NAFTA.

Previous speakers have already addressed a wide range of issues. I will therefore focus on monetary policy from the standpoint of inflation, and on the banking system.

Strong monetary and exchange rate policies are the cornerstone of Mexico's anti-inflation strategy. Given the present stance of exchange rate policy and Mexico's heavy dependence on capital inflows, tight credit policies are crucial. To meet the monetary targets despite surges in capital inflows will require more active sterilization policies and continued curbing of excess liquidity through market operations. The fact that capital inflows have not created strong pressures on the money market underlines the need for greater efficiency in this market. In this connection, I would appreciate staff comment on how well prepared the authorities are to absorb excess liquidity coming from various sources in the future.

The exchange rate policy could become problematic, given the slight but continuous loss of competitiveness and the relatively low level of Mexico's reserves. During 1993 it was possible to maintain the flexibility of exchange rate policy by widening the fluctuation band. A major policy challenge for the coming year will be how to reconcile the goal of pursuing a more flexible exchange rate policy with the goal of reducing inflation. The staff's comments on this point would be welcome.

Progress with financial modernization will provide a more efficient channel between savers and investors. However, I join the staff in noting that strengthening the regulation and supervision of the domestic financial markets will grow in importance as the financial system increases both the volume of transactions and the sophistication of its operations. Despite welcome improvements in the supervision of financial intermediaries during 1993, the nonperforming commercial bank loans are growing at a worrisome pace that threatens to crowd out credit to the private sector. Other problems include a shift in lending to riskier borrowers, as banks tend to do during economic slowdowns, and weak competition that is widening the gap between deposit and credit interest rates and increasing the financial margin, with limiting effects on future real growth. The comprehensive program for improving the efficiency of the banking sector certainly needs to be continued into 1994.

Finally, while we agree with the authorities' intention not to relax the fiscal stance, we strongly support an increase in social spending. Earlier budget surpluses have made it possible to greatly reduce the GDP share of domestic debt, and this, together with the expected decline in inflation, will help keep debt service low and contribute to the primary budget surplus. There should thus be room for the Government to ease fiscal policy slightly this year without endangering the medium-term sustainability of the budget. This would give the Government greater flexibility in responding to social needs and expanding the social safety net, with a view to raising still more households out of poverty, especially in the less developed agricultural area. The 1994 increase in social spending should also give some stimulus to economic growth, which is itself the best way of fighting poverty.

Mr. Shaalan made the following statement:

Impressive progress was achieved over the past few years in reducing the internal and external financial imbalances that beset Mexico's economy during the 1980s. The same cannot be said for economic growth. Following a significant deceleration in 1992, real GDP growth decelerated further to merely 0.6 percent last year.

The authorities attribute this slowdown for the most part to the efforts to reduce inflation to single digits relatively quickly and to restructure the economy in the face of increased foreign competition. With this assessment in mind, and against the background of the significant progress already achieved in reducing imbalances and restructuring the economy, I shall focus my remarks on the extent to which the stance of financial policies envisaged for 1994 may be judged appropriate in the light of the less than satisfactory economic growth performance in recent years. I shall also comment on some aspects of exchange rate policy and developments.

As regards fiscal policy, a shift from a small surplus in 1993 to balance in 1994 is currently envisaged. This shift is viewed as necessary to ensure a moderate improvement in growth performance and to increase social spending. I would agree with the authorities that, given the relatively low level of domestic public debt, it would be difficult to maintain a fiscal surplus in an environment of low economic growth and high unemployment. I do so with a degree of confidence, counting on the authorities' assertion that greater scope for fiscal flexibility than is currently envisaged, even if the hoped-for pickup in economic activity does not materialize, is not a policy option. This position is justified by the importance attached to achieving further progress on the inflation front while avoiding excessive reliance on monetary policy for that purpose. The staff indeed cautions that the efforts to reduce inflation in 1994 will not--on current policies--be able to count on sterilization from the fiscal side and that this would have consequences for interest rates.

However--and this leads me to monetary policy--should sterilization be carried out to the same extent it has been in recent years? I do not claim to have an unqualified answer, but it may be in the negative, given the currently depressed state of the economy and the fact that the high interest rate policy followed over the past few years has provided incentives for speculative capital inflows. There is no question that this policy has contributed significantly to the success achieved in reducing inflation. It is plausible, however, that the continued weakness of economic activity could require, and may indeed provide scope for, reducing the extent of sterilization without endangering price stability. Such a policy orientation would also serve to discourage capital inflows motivated by interest rate differentials and to redirect the inflows from financial to direct investments. Risks of overheating may attach to this policy, but the weak demand conditions currently prevailing and the winding down of the consumption boom that followed the liberalization and opening up of the economy would seem to suggest that it may be unnecessary, if not even counterproductive, to continue to pursue a policy of sterilizing inflows to the extent followed in recent years.

On exchange rate policy, the staff notes that the exchange rate band was seen as a mechanism for discouraging speculative capital inflows. I note that the authorities intend to adjust the upper band to allow for a nominal depreciation of 12 percent by year-end if market conditions require. The risks that this may entail for market confidence in the authorities' intention to preserve relative nominal exchange rate stability are clearly recognized, but these risks would seem to be discounted or at least minimized.

The report states that "while the wider band might be seen as adding to the scope for exchange rate flexibility," the authorities felt that "investors were well aware of the Government's intentions to preserve relative exchange rate stability." One should not be too sanguine about the prospects for success in striking the kind of delicate balance implied by this statement. If the envisaged stance of exchange rate policy turns out not to be perceived as credible as is hoped, then there is the risk that this stance would lead to sacrificing the benefits of relative nominal exchange rate stability while adding to interest rate risk premiums and not materially contributing to discouraging speculative capital inflows. In my view, this latter objective--discouraging speculative capital inflows--could be better served by achieving interest rate reduction through reduced sterilization, which would also hold the potential for spurring investment and economic growth. Moreover, Mexico does not seem to have a competitiveness problem as, notwithstanding a real appreciation of 8 percent in 1993, manufacturing exports grew by 17 percent during the year. I tend to agree with the authorities that some further real appreciation in 1994 would not affect competitiveness significantly because of the positive effects of structural reform.

Mr. Mwananshiku made the following statement:

I agree with the staff appraisal, and I commend the Mexican authorities for the successful implementation of their macroeconomic stabilization strategy and structural reforms. A measure of the authorities' commitment to the reform of the economy and the restoration of stability in the domestic and external sectors is reflected in the remarkable progress achieved in their economic performance. For example, the fiscal position has been stabilized, and significant progress has been made in reducing the rate of inflation, although more efforts are needed. In addition, Mexico has implemented structural reforms aimed at the liberalization of the economy and has succeeded in restoring investor confidence, resulting in substantial capital inflows. Also noteworthy is the recent decision to grant autonomy to the central bank, a critical component in the process of reforming the financial system. I hope that this will contribute to the further enhancement of the efficiency of the country's monetary policy. Moreover, the balance of payments current account has been strengthened, and a buildup of international reserves continues.

Regrettably, output growth, at only 0.6 percent, was not able to keep up with the pace of improvements registered in other areas of the economy because of lower levels of investment and consumption. However, now that the uncertainties relating to the ratification of NAFTA are over and with the expected decline in domestic interest rates, I hope that the authorities' goal of achieving a growth rate of 3 percent during 1994 will be achieved.

On other policies, I welcome the authorities' decision to allocate increased resources to social sectors and their intention to improve the living standards of the poorest of the Mexican people.

As for the external sector, ensuring enhanced competitiveness is crucial to Mexico, especially in the context of NAFTA. Maintenance of a flexible exchange rate policy and the decision to link wage increases to productivity will be important in this respect. Improvement in domestic savings and a further reduction in inflation will support the growth of the economy.

Mr. Link made the following statement:

This chair would also like to commend the Mexican authorities for their remarkable economic achievements in recent years. They have been able to move from a public finance deficit to a surplus; about 46 percent of the state enterprises have been privatized; public debt has fallen from 68 percent of GDP in 1988 to 22 percent in 1993 while external debt as a percentage of GDP has decreased from 75 percent in the 1980s to 35 percent in 1993; and the inflation rate was reduced to 8 percent in 1993.

We also welcome the most recent measures taken following the ratification of NAFTA. The opening up of the financial system to foreign competitors should reduce the high spreads between loan and deposit rates. This will especially help small and medium-sized firms, which, unlike large companies, do not borrow on the international capital market. Furthermore, the new central bank law will help to increase credibility of the Government's stabilization policies. It gives the central bank control over monetary policy, limits the credit it can extend to the Federal Government, and makes stability of the purchasing power of currency its fundamental objective.

At the same time, like other Directors we would like to point out one worrisome development, namely, the current account deficit --6.8 percent of GDP in 1992 and 5.7 percent in 1993. Up to now, this current account deficit has been financed through large capital inflows. This might become increasingly more difficult once U.S. interest rates start to rise. Beyond that, the real exchange rate has been appreciating. This, together with NAFTA and the increased competition that accompanies it, might further widen the deficit. Consequently, the authorities should keep a watchful eye on the development of the current account deficit. Further, with NAFTA in place and a balanced budget, they might have some room to reduce nominal exchange rates without reviving inflation.

Mr. Lvin noted that his points of concern had been fully covered by previous speakers. He joined those who had commended the Mexican authorities for their success.

Mr. Ismael made the following statement:

As seen in our recent discussion on Korea and Indonesia and in our present discussion on Mexico, interestingly enough, these three countries have one issue in common, namely, capital inflows. The policy challenge faced by these countries is how to limit the destabilizing effects of the inflows while not impinging on the higher growth rates that the flows afford.

The emerging view among us--the staff in general as well as the Board--is that currency appreciation is the more appropriate means of coping with capital inflows to prevent inflation from accelerating, rather than sterilization which is costly, and of compensating for the loss in competitiveness through the pursuit of structural reforms in addition to prudent monetary policy and fiscal consolidation.

Mexico has avoided overheating and the acceleration of inflation associated with capital inflows by resorting to partial sterilization, appreciation of the currency, and creation of fiscal surpluses. The associated erosion of Mexico's competitive edge has been compensated for by the pursuit of wage restraint. Additional compensation for the loss of competitiveness has been obtained by the introduction of various structural reforms.

In view of what I have stated, I wonder whether there is room for additional financial sector reform, such as further trade liberalization and imposition of taxes on capital inflows? In addition, is there room for interest reduction now that inflation has come down, thereby reducing the existing interest rate differential, which is one of the causes of capital inflows into Mexico, while avoiding jeopardizing the objective to lower inflation to 5 percent?

Another issue is external debt. Although public debt outstanding is projected to remain rather constant, private debt is projected to increase drastically--doubling from 1993 to 1998--which will result in an average increase of external debt of US$7 billion a year over the medium term. In view of Mexico's past experience, what policy or mechanism is in place to keep private external debt within manageable limits?

Mr. Bergo made the following statement:

The achievement of the Mexican authorities over the past few years in transforming the economy is quite impressive. As I broadly agree with the approach the authorities have chosen in the past, and also find their strategy for the year to come basically appropriate, I shall limit myself to a few points for emphasis.

A number of Directors, including Mr. Havrylyshyn and Ms. Lissakers, have expressed concern over the rather modest growth performance of Mexico in recent years, despite the high investment ratio, reduced inflation, and apparent rapid dismantling of structural impediments to growth. Mr. Marino attributes the slow growth mainly to the short-term transition costs, and he expects a reversal of this in 1994. It is not easy to ascertain precisely the factors behind the modest growth. While transition costs might have played an important role--perhaps the most important--and the projected growth in 1994 and onward might well materialize, in my view it is nevertheless a somewhat risky proposition to base the formulation of economic policy on an expected reversal of recent behavior of the economic agents. I welcome the authorities' intention not to relax the stance of fiscal policy beyond the one envisaged in the budget even if the economic recovery should be weaker than forecast, but I would advise the authorities to prepare certain contingency plans to deal with such an eventuality at an early date.

I share the views of others who have voiced concern over the high dependence on external financing of the investment activities in Mexico, and the correspondingly low private savings. While it can be argued that, with regard to economies in rapid transition, for a certain time investment opportunities might be easier seen by foreigners than by locals, it would certainly be unfortunate if this were to continue over a number of years, as implied by the medium-term projections.

Surges in capital inflows over and above what is required to cover the current account deficit and the maintenance of a comfortable level of reserves can be met by increased upward flexibility of the exchange rate. However, continued appreciation of the nominal exchange rate might result in competitiveness problems, a concern that has been referred to by some Directors. Furthermore, such a policy might well create expectations of further appreciation, which could encourage capital inflows even more. Therefore, I wonder whether the most appropriate response to excessive inflows would not be to stabilize the exchange rate through sterilizing the inflows. I fail to see that this should necessarily lead to higher interest rates, other things being equal.

In the area of structural reform, I generally welcome the important progress that has been made, namely, the granting of independence to the central bank, the opening of trade and investment, and the reorientation of the PECE. However, referring again to the generally modest growth and high capital/output ratio, I would nevertheless raise the question of whether further efforts should not be made to identify and remove possible structural impediments to growth.

The staff representative from the Western Hemisphere Department commented that the staff was aware that reports by other organizations suggested that poverty was not being reduced in Mexico. The accuracy and interpretation of the various reports--for example, those by the UN Economic Commission for Latin America and the Caribbean and the Statistics Department of Mexico--were the topic of much discussion in Mexico and perhaps warranted further analysis by the staff. Meanwhile, the authorities had adopted a strategy of accelerating the steps to alleviate poverty, as evidenced by developments over the past few years and the projected increase in social safety expenditures in the future.

The length of the phaseout period for agricultural price supports underscored the vulnerability of Mexico's agricultural sector, the staff representative remarked. For many years, agriculture had been subject to significant institutional and structural restrictions, but over the past two years, the Government had taken important steps to implement land reform that would allow for the breakup of land holdings and give land titles to communities and individuals that could be used as collateral and facilitate agricultural financing. He would point out that the 15-year time period mentioned in the report for the phaseout of price supports was the exact schedule incorporated in NAFTA. The Government envisaged that the change-over from the system of price supports for a selected group of commodities--in the present case, basic grains--to direct subsidies should lead to an increase in investment and productivity in the agricultural sector. The previous system of price supports had been focused on two or three commodities and had affected about 1.2 million of Mexico's 3 million farmers, the remainder being largely subsistence farmers who did not benefit. The present system, which called for a direct transfer of roughly $100 per acre to all farmers, would likely remove the bias to those few commodities and facilitate investment and increased productivity in the entire agricultural sector.

The debate on the relationship between inflation and economic growth was long running, the staff representative said. He agreed fully that bringing down inflation encouraged economic growth to the extent that low inflation gave the right signals to savers and investors. However, the process of bringing down inflation could be destabilizing in the case of Mexico, to the extent that when inflation was consistent with high real interest rates, it acted as a brake on the expansion of economic activity.

The Mexican authorities were involved in a delicate balancing act by trying to sterilize capital inflows, the staff representative commented. Doing so placed upward pressure on interest rates and, in fact, encouraged other inflows. One way of breaking that vicious circle was to aim for a fiscal surplus, but under current circumstances that was not feasible. In that light, the Mexican authorities had decided against implementing direct controls or taxes on capital inflows at the present time, although they had not totally eschewed the possibility. However, capital inflows to the banking system were currently subject to certain restrictions, namely, the 20 percent ceiling.

As to whether financial liberalization should have waited until the recovery was more in train, it was important to remember that the Mexican financial system prior to denationalization had been geared to giving credit to the public sector, the staff representative stated. The private sector--certainly the small and medium-sized industries--received most of its credit from unofficial financial intermediaries. In that context, with denationalization it had been important to liberalize the system so as to make credit available for as large a section of the productive sector as possible and to put appropriate supervisory arrangements in place so as to avoid the problems that had occurred in 1992 of increased nonperforming loans following the expansion of consumer credit.

The staff had expressed concern about the tremendous growth in private debt over the past years, the staff representative from the Western Hemisphere Department remarked. The authorities correctly argued that the expansion reflected creditors' confidence in the Mexican economy, with Mexico able to enter previously closed credit markets. If the economy continued to show strength, that trend would indicate that the borrowing was being put to correct use, but clearly the authorities should watch the situation closely.

Mr. Marino observed that the questions raised about the slowdown in economic activity--or the less robust GDP growth rate in Mexico compared with other developing countries--were the same issues that had been puzzling the economics profession for over 200 years. Therefore, he welcomed a discussion that could perhaps lead to understanding of the growth process in Mexico and other countries. Complex phenomena gave rise to various interpretations, which were not always mutually exclusive but represented different ways to analyze a problem. Several forces that had been at work might explain the slowdown of the Mexican economy since 1992, and they had been the subject of some research. Most important, when a country introduced a so-called heterodox sterilization program, the set of expectations on which economic agents based their behavior was usually not robust, and could lead to actions and decisions that resulted in inconsistencies with the new macroeconomic framework that a government had put in place. In short, credibility in economic policies took time to be established, particularly in countries that had a track record of shifts in policies and reversals of actions.

Undoubtedly, his authorities' interpretation was that low inflation fostered growth, and for that reason they were striving to achieve price stability, Mr. Marino stated. In Mexico, some production agents had lagged in adapting to the new realities of heightened external competition and deregulation in Mexico. They had based their production and investment decisions on a trajectory of prices and interest rates that had been inconsistent with the Government's objectives. The inflation forecast embodied in their decisions had been higher than actual performance. Under those circumstances, the agents had been caught with higher real interest rates and wages than the price of their product could support. In general, the reaction had been to adopt a series of measures, such as reconversion, streamlining, and re-engineering, all of which had had a negative impact on jobs, investment, and production. Caution was necessary because some of the restructuring taking place necessarily implied that some firms would not be competitive in the new circumstances, and exchange rate policy should not have to compensate for the lack of competitiveness of some firms.

A second force that operated in economies experiencing a rapid decline in inflation anchored by the exchange rate, while simultaneously undergoing an opening of the economy, was a boom in consumption and investment expenditure motivated by improved expectations about permanent income, Mr. Marino continued. That force tended to sustain growth during the first stages of the stabilization process. The expansion of demand that had occurred in Mexico during the fist phase of stabilization had been prolonged and supported by the strong inflow of capital. However, as mandated by the dynamics of the process, eventually the initial impulse had tapered off as the wedge between the actual and desired stock of durable goods and capital goods had been narrowed or eliminated. During 1993 it had been clear that those forces had started to operate, as evidenced by the declining trend in the acquisition of durable consumer goods and investment goods that ensued.

The third force also belonged to the realm of expectations, Mr. Marino said. Many market analysts attached great importance to the size of the deficit in the current account, regardless of the underlying forces generating the deficit. For policymakers, the current account deficit became a concern, if only because it was a concern for analysts. In Mexico during 1993, when uncertainties over NAFTA had intensified and the volatility of capital inflows had increased, monetary policy had had to become more restrictive. That stance, together with the credit squeeze of commercial banks, had led to the slackening of sales, accumulation of inventories, and inevitable losses in production and employment.

The type of forces at work pointed to the transitory nature of the slowdown, and that was the framework within which the authorities had based their improved outlook for 1994, Mr. Marino remarked. The consensus among foreign and domestic analysts on the outlook for 1994 was that the Government's goal of 3 percent growth of GDP was feasible, or even modest, with many forecasts hovering around 4 percent growth. The elements behind those forecasts had been discussed, such as the advances in controlling inflation and the narrowing of the trade deficit, which would allow attention to be focused on the necessary improvements in the rate of production and employment.

The slight easing of the fiscal stance, the decline in domestic interest rates, which--at about 9 percent--reflected the greater confidence of investors in Mexico, and the tax incentives should produce a gradual upturn in production during the first half of the year, Mr. Marino stated. Some indicators were already favorable: factory orders, bank lending, raw material prices, exports, and imports were all showing advances.

Although there was some divergence between different indicators, the market had certainly improved its implicit assessment of Mexico's creditworthiness, Mr. Marino reported. Mexico had been one of the first emerging market countries that had tapped regional capital markets, for example in Japan, the United States, and most recently in Hong Kong. Additionally, the declining spread had been substantial, from about 800 basis points in 1989 to about 100 basis points in the most recent placements, and the length of the maturity had improved.

A clear diagnosis was lacking of the role that social pacts played in the economy, Mr. Marino commented. Undoubtedly, the social pact was important in the initial phases of stabilization, and at present the exercise had been linked more to the budget process in the economy and as a forum for dialogue between the different sectors of society--the business sector, workers, and Government. Those wage accords had served as signals to the market. The minimum wage increases under the wage-price agreements had been aimed primarily at fostering expectations of lower inflation. Available empirical evidence suggested that the policy had been somewhat successful, as changes in the average wage were correlated with changes in the minimum wage, while real wages seemed uncorrelated with inflation.

Exchange rate policy had been the subject of intense debate, with Mr. Lanciotti advocating a narrowing of the band and a firming of the exchange rate commitment, and Mr. Smee, among others, advocating greater flexibility, Mr. Marino recalled. Guidance could be provided by the statement of Mr. Peretz, in the case of Hong Kong, that it was difficult to prescribe an exchange rate policy for a country independent of the time and of the particular circumstances of the moment. The objective of Mexico's current exchange rate policy was to give it greater flexibility, which would lead to increased competitiveness--although the markets' behavior in Mexico might indicate the likelihood of the opposite result: a nominal appreciation of the currency, given the strong capital inflows. The current strategy was to try to have the best of both worlds. Some of the turbulence in the market during late-1993 showed that in those circumstances the strategy was effective in controlling temporary speculative forces in the economy.

The savings-investment imbalance was one of the main challenges facing Mexico, Mr. Marino observed. It was necessary to foster private savings in order to address the private sector savings-investment imbalance, and Mexico, like all countries, was aware that a sustainable development process needed to be financed primarily by domestic resources, with external resources playing only a complementary role during the transition period. Several steps had been taken to fortify the institutional aspects that would promote private savings. He would note that caution should be exercised in looking at private savings statistics; their method of calculation made it difficult to analyze them across periods. And the economy's unstable macroeconomic variables, with high real interest rates, structural transformation and trade liberalization under way, and some indication of increased consumption, did not permit clear analysis of whether there was a fundamental trend that was adversely affecting private savings.

There had been preoccupation about the magnitude and composition of private capital inflows during the past few years, but the inflows had been seen as basically an equilibrium force, Mr. Marino said. Those most concerned with the phenomenon were those that assumed a greater volatility on the part of those flows as a result of unexpected changes in economic conditions or eventual difficulties of financing the current account deficit. A priori he did not see any of those concerns materializing. He continued to believe that the degree of volatility of capital inflows depended above all on the capacity of the Government to implement and maintain sound and consistent macroeconomic policies.

In Mexico, there had been a significant diversification of the external sector and as a result it was less vulnerable to movements in international interest rates, the terms of trade, oil prices, or even the level of demand in external markets, Mr. Marino noted. Usually, when the U.S. performance was weak, Mexico suffered much more. The diversification that had taken place had made the external sector more robust. Moreover, the high stock of international reserves accumulated by Mexico provided adequate room for maneuver in terms of both the stock itself and the time required to guarantee the effectiveness of the measures that would have to be taken in order to confront an external shock.

The Acting Chairman made the following summing up:

Executive Directors expressed their admiration for the dramatic transformation of Mexico's economy that has been under way in recent years. They warmly commended the authorities for their firm commitment to a stable, open, and deregulated economy. The successful pursuit of fiscal consolidation, lower inflation, and a reduced external debt burden had greatly contributed to the creation of an economic environment conducive to sustained growth. The authorities were commended for the prompt and effective action taken to restore stability in late 1993 in the face of tensions in financial markets prior to the U.S. congressional vote on the North American Free Trade Agreement.

Against that very positive background, Directors expressed concern about the recent sharp deceleration in economic activity. While it was difficult to assign weights to the factors behind the slowdown, Directors agreed that important contributing factors were the ongoing restructuring of firms in the manufacturing sector, the remaining structural obstacles and some aspects of the regulatory environment, and, particularly in 1993, the uncertainties about NAFTA. Directors supported the authorities' view that the continued strong growth in exports, along with the expected recovery in investment and the new pact with labor and business, should provide a basis for the reactivation of the economy this year.

Directors were in general agreement with the decision of the authorities to shift the overall fiscal balance from a small surplus in 1993 to equilibrium in 1994 in support of the recovery effort, and they welcomed the increased priority being accorded to social programs and the steps to improve income distribution. Nevertheless, there was a broad consensus among Directors regarding the need for a continued cautious fiscal policy. Therefore, Directors welcomed the stated resolve of the authorities not to relax the stance of fiscal policy beyond that contemplated in the budget even if the economic recovery turned out to be weaker than envisaged.

Directors observed that, given the fiscal stance, monetary policy would have to play a central role in ensuring further progress toward price stability and the convergence of the inflation rate toward that of the main trading partners. Directors welcomed steps being taken to address the deterioration in commercial banks' loan portfolios, including measures to strengthen bank supervision. Directors also supported the authorities' efforts to increase domestic and foreign competition in the financial system.

Directors expressed satisfaction with the narrowing of the external current account deficit in 1993, which was attributed in part to the economic slowdown and the unwinding of the consumption boom of the past few years as well as to the rapid growth of non-oil exports. In order to reduce the economy's vulnerability to a sudden reversal in capital flows, Directors stressed the need to lower the external current account deficit further with the aid of policies designed to strengthen private savings, which remained relatively low, and to maintain high levels of public savings. Directors also expressed the hope that there would be a shift in external financing toward a greater share of direct investment.

While some Directors expressed concern about the outlook for Mexico's competitive position, it was generally noted that, notwithstanding the real appreciation of the peso in recent years, Mexico's manufacturing exports continue to register strong gains, partly because of the effects of structural reforms that have helped to improve productivity. As further real appreciation of the peso could pose risks to continued export expansion, Directors emphasized the importance of lowering inflation and increasing wage restraint and continued structural steps to ensure export competitiveness and labor market flexibility.

Directors commended the authorities' efforts to consolidate the structural reform process through the further opening up of the economy, the formal removal of most restrictions to foreign investment, and the approval of laws granting autonomy to the Bank of Mexico. They encouraged the Government in its intention to alleviate poverty, strengthen existing social safety net programs, and improve their targeting.

In sum, Directors noted that Mexico had achieved remarkable progress in recent years. With the continued pursuit of sound economic policies and the investment and trade benefits that can be expected to come from the continued opening of the economy (including the implementation of NAFTA), Mexico's medium-term prospects remain particularly favorable.

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

2. VANUATU - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Vanuatu (SM/94/35, 2/7/94). They also had before them a background paper on recent economic developments in Vanuatu (SM/94/40, 2/14/94).

The staff representative from the Southeast Asia and Pacific Department made the following statement:

Information recently received by the staff suggests that the central government recurrent budget deficit for 1993 is likely to be lower than projected in SM/94/35. Revenues are expected to exceed the previous projection by VT 150 million, partly reflecting a pickup in tourism late in the year. As a result of a strike by public sector workers in support of a higher wage increase, the overrun in current expenditure is also expected to be lower than previously anticipated. In addition, following recent typhoons in the Philippines, the world market price of copra has increased by some 35 percent since December 1993. If this is sustained, exports would be about $2 million higher than projected in 1994, and the prospective losses of the Vanuatu Commodities Marketing Board (VCMB) would be reduced.

These developments do not change the broad thrust of the staff appraisal. While the greater than expected buoyancy of revenues is a welcome development, the level of current expenditures will pick up once the current strike is settled. An additional pay increase--over and above the 5 percent already offered--is likely to be provided to the teachers from the middle of the year. Moreover, even after the recent increase in the world copra price, the VCMB would still continue to make significant losses. Therefore, the staff would underscore the importance of a reduction in the domestic support price of copra to restore stability to the finances of the VCMB, as well as tight control of current expenditures to ensure that the budgetary targets for 1994 can be achieved.

Mr. Waterman made the following statement:

My Vanuatu authorities are in general agreement with the staff appraisal.

The challenges facing Vanuatu have not changed greatly since the previous Article IV consultation. It is a very small economy located in an archipelago with a small but fast-growing population that has a tendency to move from the rural sector to the main metropolitan area, Port Vila. Aid remains an important but declining source of income.

A large proportion of the working population is engaged in subsistence agriculture, focused particularly on activities related to the production of copra, and fishing with some useful diversification in recent years into other crops, such as kava, cocoa, coffee, and squash, and the production of beef.

Tourism has traditionally been a strong export earner and the main industry with good continued growth potential. The continued development of Port Vila as an offshore finance center has also been an important development of recent years. Manufacturing activity is very limited and is likely to remain so.

As the staff report draws out, economic activity in recent years has been affected by the impact of major cyclones and weak activity in neighboring countries as well as weak demand for copra. Tourism in particular has picked up more recently and should improve further with the stronger recovery now evident in Australia and New Zealand.

Vanuatu has adopted a cautious approach to fiscal policy since independence, with tight budgetary control aimed at securing a balanced recurrent budget. The tax base is narrow, being very reliant on import taxes, but the system is cost effective given the size of the economy and the need for a structure to process imports for other purposes. In practice, most of the tax is paid by tourists and residents of Port Vila. My authorities have been cautious about introducing a system of income taxation, particularly given its possible impact on Vanuatu as a financial center.

As the staff report underlines, continued fiscal restraint will be important in the period ahead and my authorities recognize that they will need to be cautious in borrowing to undertake infrastructure development, but such expenditure is necessary to facilitate further development of the tourist industry and meet the needs of a growing population.

The rate of inflation remains at about 5 percent per annum but could benefit from much lower rates, such as those being achieved in major neighboring countries.

The overall balance of payments position remains quite strong. Official reserves remain quite high and there has been an increase in foreign asset holdings by the private sector, but continued strength will depend on growth in the tourist sector as well as ongoing fiscal restraint.

Extending his remarks, Mr. Waterman noted that, since the staff visit to Vanuatu, copra prices had risen substantially, partly owing to problems in one of the other members of his constituency.

As the strike related to the proposal to limit the public sector wage increase to only 5 percent was continuing, Mr. Waterman suggested, it might be helpful to underline the need for fiscal restraint in the summing up of the current discussion.

Ms. Srejber made the following statement:

As I broadly agree with the staff appraisal, I will comment on only two issues: the level of development assistance and the function of the VCMB.

Vanuatu shares many of the disadvantages of being a very small island economy, such as vulnerability to external shocks, distance from foreign markets, and a very small domestic market. Vanuatu also shares some of the benefits, such as being able to attract relatively more generous foreign assistance than larger countries with similar income levels could hope for. This is perhaps a case of "the importance of not being important." This advantage is reflected in the fact that foreign grants have accounted for approximately 35 percent of total central government revenue in recent years.

In the long term, however, the advantage of easy access to foreign assistance can be turned into a disadvantage. Generous unconditional donations can foster foreign aid dependency, and foreign assistance can abruptly be reduced or cease for reasons outside the control of the authorities. Therefore, it is essential that foreign assistance be used to complement, rather than substitute for, a domestic development effort. Since foreign assistance is an important element in public finances, it would be helpful if the staff could provide some assessment of the effectiveness of foreign assistance in the past, and the future prospects of it. As Vanuatu prepares to carry a larger share of the cost of its development strategy, strengthening the public finances will be of vital importance. I fully agree with the staff on the need for a comprehensive tax reform, but I would stress that, in addition to reforming the tax structure, a significant enhancement of revenue appears to be needed in order to build a sustainable fiscal position over the medium term. Expenditure cuts seem unlikely to be sufficient, even if the scope for expenditure cuts is substantial, including subsidies to the VCMB.

It is easy to understand the desire of a small economy, which is dependent on the exports of one or a few commodities that are subject to substantial price fluctuation, to stabilize export earnings. Most countries in that situation have probably, at one time or another, at least flirted with some form of a price stabilization scheme. Most schemes, however, intellectually attractive as they may be, have proved to be rather short-lived. One of the reasons is that they have a tendency to turn into instruments for channeling subsidies to the export sector, undermining its stabilization role and causing distortions. This seems to apply to the VCMB. The VCMB is not only a source of distortion in the economy by providing subsidies to the traditional export sector, but it is also costly. The background paper on recent economic developments indicates that part of the losses of the VCMB reflect large marketing expenses accounting for, on average, 40 percent of copra sales receipts. I wonder why the marketing of copra is so expensive.

If the VCMB is to play a useful role as a tool for macroeconomic stabilization, its operation has to be fundamentally changed. First, the VCMB should be legally prevented from borrowing--a statement by the Government to this effect is not sufficient. The only source of income should come from export receipts when export prices are above the norm, say the deflated average of the past 5 years. Producers should be compensated only when prices are below the norm, and only as long as sufficient funds exist. Trends in commodity prices are difficult to determine. A moving average approach would prevent unsustainable equalization. Second, the VCMB should not seek a complete equalization of prices. There is a risk of overcompensation or excessive extraction of funds from the producers, in which case, the political sustainability of the operation will be put in danger. It is important that the producers feel some pressure from the market. For example, half the deviation from the norm could be compensated or subtracted. Third, it is probably wise to separate the marketing activity, where the VCMB has to act as an agent of the producers and the stabilization scheme; the emphasis should be on enhancing macroeconomic stability.

The need for a special price equalization mechanism should be evaluated from the point of view of its effect on macroeconomic stability; it should not be regarded as a service to the producers. That may, of course, occasionally create political pressure that will be difficult to resist, especially at times when world market prices are high, and producers receive less than full market price, at a time when supply is reduced owing to crop failure or other reasons. The experience of one of the countries in my constituency indicates that a well-functioning price equalization mechanism may be difficult to sustain politically; and a mechanism that does not work properly may be worse than no price equalization at all.

The forthcoming discussion on the behavior of non-oil commodity prices will provide the Board with an opportunity to discuss this matter further.

Mr. Wei made the following statement:

As we agree with the main thrust of the staff report and the major points expressed by Ms. Srejber, I can limit my intervention to a few remarks.

The authorities correctly have made it a key priority to reverse the deterioration in the 1993 fiscal position as the deficits of both the central government and the VCMB have increased. The authorities' objective of restoring a balanced recurrent budget for the Central Government in 1994 is also encouraging. According to the staff report, the improvement in the recurrent budget could be achieved entirely through a reduction in recurrent expenditures. It is our view that revenue measures should be strengthened, particularly in terms of expanding the tax base. We agree with the staff that the reduction in recurrent expenditures by 3.25 percent of GDP is ambitious, in light of the projected shortfall in revenues. If this objective is not met, policy credibility will be damaged. I wonder whether the staff could comment on the performance of the special funds. We agree with the staff that the 1994 budget target could be met only if outside budget expenditures are avoided. I wonder whether the authorities would consider incorporating these special funds into the budget.

On the other hand, a more efficient use and some reorientation of expenditures may be considered to support economic diversification. In this context, we join the staff in urging the authorities to consider the long-term role of the VCMB. It may be better to start the reform in a gradual and cautious way instead of delaying the adjustment.

Like most of the Pacific island countries, the Vanuatu authorities face a variety of geographical constraints to economic development, making them vulnerable to external shocks. They have formulated a development strategy centered on encouraging private sector development, thus diversifying the economy and promoting growth. A solid infrastructure base is a precondition for a dynamic private sector. In this context, we welcome the authorities' ambitious plan to finance a program of new investment projects designed to meet infrastructure needs and enhance growth prospects over the medium term. We agree with Mr. Waterman that such expenditure is necessary to facilitate further development of the tourist industry and meet the needs of a growing population. Given its serious impact on the budget, we agree with the staff that the program be implemented cautiously. The authorities should be encouraged to strengthen their managerial capacity to increase the efficiency of the development program.

We welcome the authorities' intention to introduce more competition and reforms into the banking system. Their interest in seeking Fund assistance to enhance their supervisory capacity deserves support. However, much of the overall deficit was financed through the Reserve Bank and threatened the effectiveness of monetary policy, already constrained by the openness of the capital account and the fixed exchange rate. We do not see any reform measures from the authorities addressing this issue. I wonder whether the staff could comment on this.

Mr. Cailleteau made the following statement:

It goes without saying that a substantial improvement in the quality of economic data is required if the authorities expect the Board to achieve its role of surveillance. In particular, it seems to me that, as pointed out by the staff, special funds should be incorporated into the budgetary process and data; the transparency would thus be increased. But I am also fully aware that a good statistical apparatus is somewhat of a luxury.

One can regret the absence of significant developments on the unemployment issue. In particular, what will be the global implication of the proposed civil service retrenchment?

On the monetary and financial areas, let me first underscore our support for the nominal anchor monetary strategy. As regards the high level of lending rates and the possible "cartel-like" behavior of the banks, we feel that the adoption of the "truth-in-lending" regulations would be welcome. Could the staff tell us more about this kind of regulation as a high level of lending rates is not a Vanuatu-specific situation. Anyhow, one might recall that the spread is not as worrisome as in the case of Mexico.

Also, the improvement of the supervisory capacity of the regulatory institutions in Vanuatu is highly necessary, all the more so given that the authorities apparently rely on the development of the offshore financial sector.

To conclude, let me commend the authorities for the broadly prudent macroeconomic management of an economy structurally vulnerable to adverse external shocks.

Mr. Dorrington made the following statement:

The recommendations put forward by Ms. Srejber on the commodity stabilization issue would represent a great improvement over the current position, although cases of overoptimism on what can be achieved by attempts at commodity stabilization abound generally. A recent staff paper on the behavior of non-oil commodity prices (SM/94/32, 2/2/94) shows that relying on backward-looking moving averages is not as reassuring as it might at first appear. However, I will concentrate most of my remarks on the debt indicators in Table 5 of the staff report, which are at the same time reassuring and potentially worrying.

The debt indicators in Table 5 are reassuring, because the levels of both internal and external debt are reasonably low. They are worrying, because the trends are distinctly adverse. As numerous other cases demonstrate, it is far easier to prevent an unstable debt cycle starting than it is to stop it once it has begun. As the staff report demonstrates, preventive action is urgently needed. All public expenditure, including on wages, needs to be carefully evaluated and prioritized, projects financed by nonconcessional debt should be given particularly critical consideration. Given the genuine expenditure priorities, there is also a strong case for revenue measures. Of course, the implications for the Finance Center need to be taken into account in determining the precise nature of the measures, and the decisions will not be easy. That is no reason for prevarication. The authorities have received a substantial amount of technical assistance from the Fund and elsewhere. At this stage, what is needed is implementation.

Mr. Abbott said that he was in general agreement with the analysis and recommendations presented in the staff report. However, he wondered whether the staff could offer further comments on the Reserve Bank's supervisory role in the banking system. The staff report indicated that banking supervision in Vanuatu was quite limited, and he supported the authorities' request for technical assistance in that area. Indeed, from the information contained in the background paper, there appeared to be almost no supervision of the Finance Center. For example, offshore companies could be registered in any language, the Directors of such companies did not have to reside or hold meetings in Vanuatu, shareholders could hold bearer shares offshore without any nominee shareholders onshore, no annual meetings of shareholders were required, and no annual returns were needed to renew registrations. As the operations of the Finance Center accounted for about 13 percent of GDP and the number of offshore banks had recently risen from 108 to 114, the lack of supervision over the Finance Center was a cause for serious concern. It would be helpful if the staff could provide detailed information on the operations of the Finance Center in its report on the next Article IV consultation with Vanuatu. He supported the Government's intention to establish a commission to examine issues related to the supervision and regulation of the Finance Center.

Mr. Murphy stated that he agreed with Mr. Abbott that it was regrettable that the Finance Center had expanded and had been restructured before an adequate supervisory framework had been put in place. He supported Mr. Abbott's comments for the current discussion.

Mr. Ishida made the following statement:

Because Vanuatu is, like other Pacific islands, a very small and isolated country, its economy is fragile and influenced to a great extent by such external factors as the weather and foreign assistance. In order to attain the goal of sustainable growth, policy measures should be tailored to the unique circumstances of Vanuatu. From this basic standpoint, I will comment on the necessary measures to be taken.

First, with a view to minimizing fluctuations in economic growth, I urge the authorities to facilitate a shift away from dependency on agricultural production and put more emphasis on the development of service-related industry. Also, in light of the tendency of the fast-growing population to move away from rural areas to the main metropolitan area, it seems to be crucial that the authorities prepare a basis to provide more jobs for the next generation.

However, I agree with the staff that the main priority is to reverse the deterioration in the fiscal position, and that the shift to service-related industry should be implemented not by public investment, but by encouraging private sector activities.

In this respect, I welcome the recent steps taken by the authorities, especially the improvement of the competitiveness of the Financial Center. However, I urge them to make further efforts, including lowering the bureaucratic hurdles faced by potential investors.

Second, in spite of the need for budget consolidation, it is essential for Vanuatu to make every effort to develop the infrastructure needed to facilitate the further development of the tourist industry and meet the needs of the growing population.

I agree with the staff that, in order to make this effort effective, the authorities should improve the efficiency of public investment through the introduction of a formal public sector investment program and an annual development budget.

To ensure sufficient and stable revenue for public investment, the efficiency of the tax system should be improved, and additional efforts to broaden the tax base are required. However, I can understand the authorities' argument that the introduction of personal income taxes could adversely affect the operations of the Finance Center. I hope that the authorities will seriously consider the alternative of introducing a new indirect tax that could avoid this problem and continue to strengthen administrative capacity for the tax reform in the future in consultation with the Fund.

The staff representative from the Southeast Asia and Pacific Department commented that, like many other islands in the Pacific, Vanuatu had relied on substantial foreign assistance to help finance its development over the past few years. However, the level of foreign assistance, in particular bilateral aid, to Vanuatu was likely to decline from the current high levels. Indeed, the recent decline in development expenditure reflected a sharp drop in concessional aid inflows. Therefore, any attempt to maintain development expenditure, such as addressing Vanuatu's many infrastructural and other development needs, would imply greater reliance on the mobilization of domestic resources. The staff fully agreed with Directors on the need to expand the domestic revenue base, to improve the efficiency of tax administration, and to enhance the efficiency of expenditures through further prioritization.

The staff and the authorities agreed that there was considerable scope to streamline the civil service, the staff representative said. The authorities intended to move ahead rapidly with the planned retrenchment of at least 200 civil servants and to limit the public sector wage increase to 5 percent. As to the provision of a social safety net, it should be noted that retrenched workers would be compensated by varying amounts of up to 12 months of salary, depending on their length of service.

As Directors had noted, the fiscal position had significant implications for monetary control, the staff representative stated. Vanuatu had limited instruments of monetary policy, and borrowing from the Reserve Bank to finance the deficits of the Central Government and the losses of the VCMB had made monetary control even more difficult.

Although the staff did not have detailed information on the 20 special funds that were used to finance specific activities, the available data suggested that they had generally been in small surplus in recent years, the staff representative continued. While the number of special funds had been reduced over the past few years, the staff strongly agreed with Directors that the special funds should be incorporated in the budget.

The staff also agreed with the comments put forward by Ms. Srejber on the future role of the VCMB, particularly with respect to the need to maintain macroeconomic stability, the staff representative commented. The European Union was conducting a study on the issues related to the future role of the VCMB, and it was expected to present a report to the authorities in early March 1994. In that connection, a key question would be whether the VCMB should play a price stabilization role at all, or whether it should become a marketing organization. Whatever role the VCMB assumed, it would be essential for it to pursue sound financial policies and a pricing strategy that would be consistent with the long-term need for economic diversification away from copra production toward other higher value-added crops.

The substantial marketing costs of the VCMB reflected the high cost of exporting most of Vanuatu's copra to Europe and Bangladesh before processing, the staff representative considered. In an effort to reduce high freight costs, the authorities were trying to renegotiate their contract with the shipping agency and to either establish a copra processing plant in Vanuatu or increase exports to neighboring countries that had processing facilities.

The high level of lending rates in Vanuatu was attributable to a number of factors, including the relatively oligopolistic position of the banking sector, high administrative costs, and the perceived riskiness of lending to local entrepreneurs, the staff representative said. Under the current banking practices, quoted lending rates were very poor indicators of the true lending rates charged to many entrepreneurs. Given the widespread practice of requiring countervailing deposits and other fees and charges, the adoption of "truth-in-lending" regulations would enhance competitiveness by obliging banks to inform borrowers of the true cost of lending, thereby enabling them to shop more effectively for loans.

The offshore Finance Center was very important to the Vanuatu economy, as it accounted for about 13 percent of GDP and provided one of the few sources of employment for skilled workers, the staff representative noted. The authorities were aware of the need for strengthened supervision of the offshore Finance Center, and they had proposed the establishment of a Financial Services Commission to supervise and regulate the Finance Center. The authorities also intended to propose additional legislation to ensure that the Financial Services Commission would be given sufficient authority to fulfill its mandate.

Mr. Waterman thanked Directors for their comments, which would be conveyed to his authorities. Like other Pacific island countries, Vanuatu had relied on substantial foreign assistance for its development in the past. Nevertheless, the authorities had accepted the fact that the level of foreign assistance inflows was likely to decline in the future and that they would be faced with a period of adjustment.

He agreed with other Directors that experience in other countries showed that the operation of commodity price stabilization schemes was rarely satisfactory, Mr. Waterman said. Such schemes were generally based on the assumption of unlimited capital and an unlimited supply of the commodity in question; such conditions almost never existed. Therefore, it was very important to ensure that prices were closely related to market developments. However, the authorities of countries, like Vanuatu, were often driven by other considerations, such as the need to redistribute income within the country. In such cases, there was an additional need to ensure that price stabilization schemes would not lead to economic distortions. He would certainly convey Directors' comments on the future role of the VCMB to his Vanuatu authorities. At the same time, however, it should be noted that world copra prices had recently increased, and they were expected to continue to increase during the 1990s.

It would be essential for Vanuatu to carefully monitor the external debt situation in the future, Mr. Waterman stated. In that respect, the recent trend toward higher levels of debt was a cause for concern, which underlined the need for further fiscal consolidation measures, such as the civil service retrenchment and rationalization currently under way.

While he agreed with Directors on the need for tax reform, it was important to bear in mind that in small island economies, like Vanuatu, the kinds of tax structures commonly found in industrial countries were not readily applicable, especially given the need to ensure that the tax system was cost effective, Mr. Waterman commented. Countries that had small populations with low incomes distributed over vast geographical areas had to rely heavily on import duties and business license fees.

The Finance Center was subject to some supervisory regulations, Mr. Waterman noted. However, their legislation relating to trusts was broadly based on legislation that was established in the United Kingdom in the 1920s, and needed to be reviewed.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the thrust of the staff appraisal. Given the signs of a rebound in economic activity, the immediate priorities for macroeconomic policies in Vanuatu were to strengthen the fiscal position and to reduce structural impediments to growth in order to meet the needs of a rapidly growing population, which would help enable the country to adjust to reductions in foreign aid.
>
> Directors observed that overruns in current expenditures, combined with the substantial losses incurred by the Vanuatu Commodities Marketing Board (VCMB) had resulted in a sharp deterioration in the fiscal position in 1993. Against this background, they welcomed the authorities' intention to balance the recurrent budget in 1994; indeed, given the medium-term fiscal

outlook, and the sharp decline in foreign grants, they considered that a recurrent surplus would be desirable. Achievement of the budget target would require a significant improvement in expenditure control; in addition, it was crucial that the proposed reduction in the size of the civil service be implemented expeditiously and that the civil service wage increase be held to the budgeted level. To stem the losses in the VCMB, Directors underlined the need to reconsider the level of domestic procurement prices for copra and cocoa. More generally, there was an urgent need to review the VCMB's longer-term role and to place it at least on a self-financing basis. The authorities should also consider the possibility of separating the VCMB's marketing efforts from the stabilization efforts. More generally, skepticism was expressed about the role that commodity price stabilization funds could play in an economy.

Directors observed that the steady decline in foreign grants, which had in recent years accounted for over one third of central government receipts, had been matched by a sharp fall in development expenditures in recent years. While recognizing the need to increase development expenditures, especially for infrastructure, Directors felt that the proposed borrowing program, which would result in a significant further increase in budgetary debt-service costs over the medium term, should be implemented cautiously; projects should be carefully selected and appraised, and concessional financing should be sought where available. Over the medium term, Directors emphasized the need to restrain nonessential current expenditures and to improve the buoyancy and the efficiency of the tax system.

Directors also emphasized that the supervisory capacity of the Reserve Bank should be improved with reference in particular to both domestic and offshore banking activities. The factors contributing to the high spread between deposit and lending rates should also be addressed, and remedial action taken as necessary.

Directors noted that measures to encourage export diversification, strengthen human resource development, and remove impediments to private sector activity and foreign direct investment would be crucial to support growth over the medium term. Directors underlined the need to address the deficiencies in the statistical base, which hinder economic analysis.

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

3. GUINEA-BISSAU - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Guinea-Bissau (SM/94/18, 1/14/94). They also had before them a background paper on recent economic developments in Guinea-Bissau (SM/94/38, 2/11/94).

The staff representative from the African Department made the following statement:

> This statement provides information received by the staff subsequent to the issuance of the staff report for the 1993 Article IV consultation with Guinea-Bissau (SM/94/18, 1/14/94).
>
> Preliminary data indicate that in 1993 money plus quasi-money increased by 35.1 percent and the rate of inflation was 29.6 percent on an end-of-period basis, which compares with the estimates of 39.6 percent and 32 percent, respectively, contained in the staff report.
>
> The smaller than estimated increase in the money supply reflected an unexpectedly pronounced weakening of the net foreign assets position of the banking system during the last quarter of 1993, as well as a further slackening of private sector demand for credit. At the same time, over the October-December period, net bank claims on the Government increased sharply, owing to unanticipated fiscal pressures. For 1993 as a whole, the increase in net bank credit to the Government accounted for 6 percentage points of the monetary expansion; this compares with the estimated contractionary impact of 18 percentage points shown in the staff report.
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> By end-December 1993, the authorities reduced the spread between the buying and selling rates in the official foreign exchange market from 3.5 percent to 2 percent, thus eliminating a multiple currency practice subject to Fund approval under Article VIII. At the same time, the premium in the parallel exchange market narrowed from 3.5 percent to 2 percent. In 1993, the Guinea-Bissau peso depreciated by 24.5 percent vis-à-vis the U.S. dollar.
>
> A draft government budget for 1994 has not yet been presented to the National Assembly. The delay is apparently associated at least in part with the first multiparty elections scheduled to place in late March 1994.

Mr. Santos made the following statement:

> Guinea-Bissau's economic and financial performance in 1993 should be assessed against the backdrop of the sharp reversal of

the terms of trade gains, the drastic decline in net inflows of external financing, and the uncertainties created by the difficulties among the different political parties in reaching a consensus on a timetable for multiparty elections. While these factors weighed heavily on the country's performance under the Fund-monitored program, important progress was made in 1993 toward stabilizing the economy and fostering economic growth. As indicated in the staff report and in the buff supplement, economic activity picked up noticeably in 1993 led by favorable developments in the agricultural sector, inflationary pressures subsided, and both the overall fiscal and the external current account deficits narrowed. Moreover, the gap between the official and parallel exchange rates reached its lowest level.

The consultation discussions held in Bissau in November 1993 provided my authorities with the opportunity to review with the staff developments in the key areas of economic policy and to reach an understanding on the additional measures needed to build on the progress achieved in 1993. They are in broad agreement with the staff appraisal and with the thrust of financial policies and structural reforms recommended by the staff.

In the fiscal area, the objective of raising the primary surplus to 3.5 percent of GDP in 1994 is predicated on the phased increase in rice import duties, the continued strengthening of tax administration, including the collection of tax arrears owed by petroleum companies as well as the close monitoring of domestic sales of grants-in-kind. With regard to expenditure, efforts will continue to be focused on containing the wage bill, curtailing other nonpriority current outlays and strengthening the PIP budgeting procedures. A draft 1994 budget, in line with the understanding reached with the staff, is on the agenda of the council of ministers for March 1, 1994 and will be submitted shortly thereafter to the National Assembly for approval. Pending its adoption by the National Assembly, the authorities will continue to be guided by the thrust of the understanding reached with the staff. Nevertheless, it should be stressed that the projected terms of trade losses in 1994 which will affect both growth performance and tax revenue combined with a limited room for maneuver on the expenditure front will present my authorities with a great challenge for the realization of their fiscal targets in 1994. To meet this challenge, they will continue to explore all realistic avenues for fiscal consolidation.

In the monetary sector, the policy remains the reduction in the expansion of domestic liquidity in order to contain inflationary pressures. Although the recent decline in inflation provided an opportunity to reduce the structure of interest rates toward the end of the year in order to support private sector activities, credit policies will remain prudent.

In the external sector, the weak foreign reserve position and the continued decline in net external financing exacerbated Guinea Bissau's payments difficulties. My authorities expect that concessional flows will resume as the adjustment process takes hold. In the meantime, they will continue to strengthen their adjustment efforts and explore prudent avenues to ease their difficult payments situation. Over the medium term, the intention is to pursue actively export diversification through the development of the fishing and the forestry sectors. The reforms of the exchange system will be pursued as well as the objective of containing the spread between the parallel and the official markets.

With regard to structural reforms, my authorities are pursuing their public enterprise reform agenda with the main emphasis on privatization. Significant progress was achieved early in the process but the technical and financial situations, as well as the difficult political situation have not been conducive to concluding further sales. With regard to the civil service reform, resource constraints have prevented the broadening of the voluntary departure program. Donor support will be solicited to extend the departure program to other levels of the civil service.

In conclusion, despite the progress achieved in 1993, my authorities remain concerned that adverse terms of trade developments, declining external assistance and the unsettled political situation could continue to hamper economic performance. However, with the significant improvement in policy implementation achieved in 1993, under extremely difficult circumstances, and given the willingness to consolidate the adjustment further in 1994, the Guinea-Bissau authorities are hopeful that discussions on a medium-term program that could be supported by ESAF resources could resume as soon as possible.

Ms. Bessone Basto made the following statement:

The economic situation of Guinea-Bissau showed some improvement in 1993: the rate of growth of GDP exceeded that of the population; there was a moderation in monetary expansion, which contributed to a significant decrease of the inflation rate, from 70 percent in 1992 to 48 percent in 1993; exchange rate distortions were reduced; government expenditures were restrained; and, the current account deficit narrowed. However, the economic situation continues to have serious problems. There was a reversal in the capital flows leading to an increased deficit of the capital account that totally offset the gains in the balance of trade. Although there was an improvement in the fiscal budget, it fell significantly short of the program's objectives owing to a poor revenue performance. As to the exchange rate system, the existence of a parallel exchange rate market contributes to distortions in prices and restrictions in international payments.

The weakness of the economy and the high domestic and external imbalances make increasingly difficult the implementation of sound fiscal and monetary policies and structural reforms that the country deeply needs. In addition, the debt situation and its very heavy servicing make the prospects for solid noninflationary economic growth in the near future seem unlikely.

I agree with Mr. Santos that, in analyzing the economic situation of Guinea-Bissau, the fact that the country experienced exogenous adverse conditions, such as a reversal in terms of trade gains and a decline in net inflows of external financing, should be taken into consideration. However, the vulnerability of the economy to external shocks is aggravated by the existence of structural problems.

Although there was an improvement in the current accounts in 1993, the strong dependency of exports on a single product, namely, cashew nuts, contributes to the extreme vulnerability of the trade balance to market conditions for that product, whose prices are subject to some volatility. Therefore, efforts to diversify exports are needed and should be taken.

The high level of inflation, reflecting the depreciation of the peso and leading to high nominal interest rates, make it difficult to rely on domestic investment as a source of growth. Although a tight monetary policy contributed to some moderation in consumption, leading to an improvement in the savings rate in 1993, the amount of domestic savings was still negative 4 percent of GDP. In addition, insufficient availability of imported inputs as well as skilled workers contributed to the difficulties in attracting foreign investors.

With respect to monetary policy, I welcome the measures taken to control inflationary pressures. However, to alleviate the burden that such measures impose on private investment, it is important that a more significant effort be made to decrease the size of the budget deficit so that the task of controlling inflation does not have to rely mainly on monetary policy.

The fiscal performance exhibited some improvement in 1993 owing to restrains on total expenditures and net lending. While I welcome the steps taken, especially with respect to the reduction of the wage bill in the public sector and the reduction of non-priority current outlays, further efforts are needed. In the revenue side of the budget, the situation weakened in 1993, as the receipts from fishing licenses fell and revenues from the privatization of public enterprises were lower. Although there was an increase in tax revenue owing to several measures taken to improve its collection--especially with respect to international trade taxes--it was not enough to compensate for the decrease in nontax revenues, which constitute the major source of revenue.

I welcome the structural reforms aimed at rationalizing the civil service and the public enterprise sector. However, the results achieved are not yet very encouraging. According to the staff report, the civil service reform was implemented with three main objectives: reducing the number of employees; enhancing the transparency of the salary structure; and establishing incentive schemes to attract and retain competent staff. So far, only a small reduction in the number of employees has occurred since the last two targets were not attained. With respect to public enterprise reform, privatization measures were not successful, owing to the difficulty in attracting foreign investment.

In light of these considerations, it is fair to recognize that, despite the difficult economic situation, some measures have been taken aimed at economic stabilization. However, to achieve a sustained growth rate in the future, other significant efforts have to be made, particularly with respect to providing incentives for investment, finding other sources of exports, improving fiscal revenue collection, and promoting the unification of the exchange rate system. Owing to the very high debt-service ratio, I agree with the staff that recourse to external financing, other than on highly concessional terms, should be avoided. Although further steps are needed, policies have been implemented in the right direction, and the authorities showed commitment in following their program.

Mr. Fontaine made the following statement:

Since the previous Article IV consultation, the authorities have made serious attempts to bring the macroeconomic situation under control. The money supply expansion was significantly reduced in 1993, while the increase in government expenditures was restrained. The actions taken so far have begun to pay off, as evidenced by the deceleration in the pace of inflation and the reduction in the external current account deficit along the lines of the agreed targets.

These developments are encouraging, but performance could be improved. The revenue performance has remained disappointing, partly as a result of delays in adopting corrective measures. Thus, the fiscal targets agreed under the staff-monitored program were not met. While progress has been achieved in monetary policy, aimed at ensuring positive interest rates, monetary and credit targets were not met. In particular, net bank credit to the Government has increased.

The bulk of the authorities' efforts should clearly be focused on fiscal consolidation. I welcome the indication in Mr. Santos's opening statement that the draft budget for 1994, in line with the understanding reached with the staff, will be submitted to the National Assembly for approval soon. I understand that the delays can be associated mainly with the forthcoming return to multiparty elections, which is welcome.

Resource mobilization needs to be strengthened through several measures, including timely increases in tariffs on rice imports, collection of arrears and counterpart funds, and improvements in customs and tax administration. However, structural weaknesses in revenue collection could be addressed only in the medium term. Indeed, the distortion between tax and nontax revenues, and between domestic taxes and import-related taxes, as well as the high exposure of revenue performance to external interests, fishing license beneficiaries, and cashew nut buyers could be corrected as the real economy improves.

Therefore, it will be important not to lose momentum in the expenditure restraint stance, including with respect to capital expenditures. In this respect, the high ratio of gross public domestic investment to GDP--although reduced in 1993--seems unsustainable: it does not translate into a higher level of economic growth, which remains modest; it seems to be a strong vehicle for excessive external borrowing; and, it generates recurrent expenditures that current revenue is not likely to cover.

For these reasons, the rationalization of the public investment program, with World Bank involvement, would be a very important step in the right direction.

As to structural reforms, I welcome the recent unification of the exchange system.

I wonder whether the delays in implementing the privatization program for public enterprises should be attributed to delays in completing evaluation reports or to the wider issues mentioned by the authorities. The authorities clearly continue to face difficulties in implementing their adjustment program.

Moreover, the authorities' efforts are hindered by the debt problem. In addition to the very high level of outstanding debt and debt-service payments, Guinea-Bissau's rescheduling endeavors are further complicated by the share of multilateral creditors and by the bilateral debt contracted after the cutoff date specified under previous arrangements concluded with the Paris Club.

Guinea-Bissau has no alternative but to embark on a vigorous adjustment path. At a time when CFA franc countries are strengthening their adjustment process, this would be consistent with the needed convergence of financial policies that should accompany Guinea-Bissau's request for admission to the CFA franc zone.

Adoption of a budget for 1994 consistent with the staff's recommendations as well as a renewed commitment to key structural reforms could pave the way toward the formulation of a program that could be supported by the Fund.

Mr. Havrylyshyn made the following statement:

The large financial imbalances in Guinea-Bissau make it a classical example of a country in need of a forceful stabilization policy. As is often the case, a bold fiscal consolidation program should be at the heart of this policy, and we welcome the indication in Mr. Santos's opening statement that the authorities are aware of this challenge and will continue to explore all realistic avenues for fiscal consolidation.

It is encouraging to note that, in 1993, Guinea-Bissau made some progress in redressing its imbalances and in establishing a track record that could justify a new Fund-supported program. Nevertheless, slippages have occurred in the current staff-monitored program, especially in the fiscal area, although the fiscal targets--which included, inter alia, an improvement of the primary balance by nearly 6 percent of GDP--were rather ambitious.

For 1994 and beyond, the staff is correct to emphasize the need for restrictive demand management policies, to be buttressed by appropriate and carefully chosen structural measures. In view of the very large macroeconomic imbalances remaining, I would caution against too much preoccupation with economic growth in the short term. Real growth is consistently mentioned first among the objectives to be achieved. In the circumstances, every program--supported by the Fund or not--should aim at creating an environment conducive to growth, both by the restoration of macroeconomic equilibrium and structural adjustment. Sustainable growth will then follow soon. Too much emphasis on short-term considerations, which might be reflected in the authorities' concerns about the adverse impact of high real interest rates on the demand for private sector credit, can seriously hamper efforts to establish sustainable growth conditions. In this respect, it should be noted that, over the past five years, real growth consistently has been above 3 percent, yet there are no signs of sustainable development in the future.

Restrictive demand management policy is needed not only to improve Guinea-Bissau's very vulnerable position in a direct way, but also to convince the international community that the country merits exceptional assistance on highly concessional terms, as the staff points out. A Fund-supported program, based on the re-establishment of a sound track record, could be instrumental in this respect. Therefore, it is regrettable that net bank credit to the Government is in an expansionary stance, rather than moving toward the expected contraction.

As I have indicated, fiscal consolidation should be the centerpiece of the stabilization efforts. While I do not have much to add to the staff's observations and recommendations in this respect, it should be stressed that a significant strengthening of revenue performance is required. The staff's medium-term scenario envisages a near doubling of tax revenues relative to GDP over a period of five years. While part of this considerable improvement should come from import taxes, and I agree with this solution as a second-best option for obvious reasons, I would warn against the creation of distortions, which can result in relatively lower tax incomes when economic agents shift away from too heavily taxed import items. From the information contained in the background paper, it seems that this may have happened in 1992.

In addition, I agree with the staff that the composition of the public sector investment program should be screened more carefully in order to lower its capital/output ratio. In view of the unbalanced distribution of investment expenditures over different sectors and the large swings that have occurred in it, I wonder whether the present public investment program represents the preferences of the donor community rather than the needs and absorption capacity of the country. In this respect, the World Bank could play a useful role.

Mr. Moss made the following statement:

Let me start off by commending the authorities for the welcome progress made over the past year in the areas of macroeconomic policy, structural reform, and statistics. This headway will certainly help Guinea-Bissau in addressing its still large internal and external imbalances and will facilitate the structural adjustments which, over the medium term, should result in a more diversified export base. It is still going to be a major undertaking that will require a significant amount of external assistance, both financial and technical. The Fund will undoubtedly play a central role in such an effort, and Mr. Santos's opening statement underscores the authorities' awareness of these matters. It is to be hoped that, after the elections, the new Government will be in a position to quickly finalize negotiations on a Fund-supported adjustment program, which could pave the way to much-needed debt relief. Given the stock of external debt and the debt-service ratio, which is among the highest in the world, there is little time to lose. Moreover, 1994 will offer Guinea-Bissau a unique window of opportunity in at least two respects: first, the favorable decision recently taken by the Fund on the initiation of the ESAF successor gives Guinea-Bissau potential access to low-cost Fund resources; and second, the recent approval of Guinea-Bissau's request for membership in the West African Monetary Union (WAMU) comes at a crucial moment when the WAMU is embarking on a new phase of economic cooperation in the wake of a significant exchange rate adjustment, as already indicated by Mr. Fontaine.

With the benefit of the staff-monitored program for 1993, the policy areas that require immediate attention are pretty clear, and I have little to add to the staff report in this respect. The staff report contains highly useful comparisons between Guinea-Bissau's performance and the average for sub-Saharan Africa or low-income countries, in particular with respect to tax revenues, and spending on health and education, and investment versus GDP growth results. I would recommend continuing to use such comparisons in staff reports for other small economies. These simple figures clearly bring out some of the areas where policy adjustments are needed.

I wonder whether the staff could comment on some specific issues not covered in the staff report: the required convergence with other members of the WAMU and what that will entail in terms of initial exchange rate action; the persistently negative savings rate in Guinea-Bissau; and, the role of the industrial sector in the drive toward export diversification.

As to the necessary convergence with other members of the WAMU, the rate of inflation will clearly need to come down further this year and beyond, and the budget deficit will have to be reined in more, particularly through a revenue-raising effort. Meanwhile, the real effective exchange rate seems to be considerably overvalued not only because of the recent exchange rate adjustment in the CFA franc zone, but also because Guinea-Bissau's inflation rate considerably outpaced that in its trading partners last year when the nominal effective exchange rate index was rather stable. I wonder whether the staff could provide more precise indications of the extent of the overvaluation of the currency and the need for a substantial exchange rate adjustment in order to enter the WAMU zone at a competitive position.

From the selected economic and financial indicators I note that gross domestic savings have been negative since 1989. It is particularly striking that a further deterioration is expected in 1994, despite a projected improvement in the fiscal accounts, on the one hand, and the authorities' conviction of the usefulness of positive real interest rates, on the other hand. Savings data can be notoriously volatile in developing countries, and I note from the background paper that private commercial banks are a relatively recent phenomenon in Guinea-Bissau. I wonder why the staff does not expect a less negative savings outcome for this year.

With respect to the drive toward export diversification, the decline in the industrial sector since the late 1980s is a cause for concern. The background paper notes as contributory factors: shortages in electricity, fuel and spare parts; insufficient availability of imported inputs and skilled local workers; and the small size of the domestic market. The interenterprise arrears in the public sector have also played a role. In the circumstances, it will be highly useful for the authorities not to concentrate solely on external policy measures in trying to attract foreign investors, but to take measures that will benefit the domestic sector directly. Settling interenterprise debt and privatization will certainly be useful in this respect, but they will not be enough to ensure a take-off for the industrial sector. A program supported by the ESAF will probably have to focus specifically on this issue. Of course, this will also mean focusing on macroeconomic stabilization and, thus, on creating the appropriate conditions for growth.

Mr. Ryan made the following statement:

We agree with the staff that Guinea-Bissau has registered rather impressive progress in the face of some daunting challenges. These challenges include the need to cut back an excessively large public sector, come to grips with a very heavy debt burden, and get control over the rapidly rising rate of inflation.

While none of these objectives have yet been completely attained, the achievements under the shadow program in 1993 were not insignificant. Targets were met, or nearly met, with respect to real GDP growth, the rate of inflation, the external current account deficit, and the reduction in the size of the civil service. Significant progress is apparent in reducing monetary expansion, raising real interest rates, cutting government spending, and reducing exchange rate differentials. We also note progress in reducing net bank claims on the Government.

The major problems at this point are in the fiscal area, particularly the need to further strengthen revenue performance; the need for faster progress in privatization; and the continuing very heavy debt burden.

We generally concur with the program laid out in the staff report, especially the prescriptions for improved revenue performance. While we agree with the objective of reducing the size of government, with particular reference to current expenditure, we wonder whether the level of capital spending should not be cut back even more than recommended owing to the absorption problems and low rates of return mentioned in the staff report, with the difference left to an expanded private sector. Mr. Havrylyshyn's comments on this topic were particularly interesting, and I look forward to the staff's response.

A stronger private sector also will be fostered by more rapid progress in privatizing or liquidating public enterprises. This should also help to address the public debt problem and encourage economic diversification--always a difficult challenge in a small economy.

Mr. Cathcart made the following statement:

Guinea-Bissau's performance in 1993 under the Fund-monitored program has been patchy. Growth and inflation rates have turned out in line with the targets, but the fiscal position--while much improved from 1992--came out much worse than programmed. Significant progress was made in the area of expenditure, but revenue has slipped. For that reason, I agree with the staff that measures to boost revenue should be put in place as a matter of priority. Raising the import tariff on rice, while being an unpopular measure, will send appropriate signals of government determination. It will also be easy to collect and will boost revenue quickly. Improvements in tax administration, focusing perhaps on customs inefficiencies, will help as well.

However, I am less persuaded by the staff suggestion that taxes on cashew nut exports should be cut in order to boost exports. This seems to suggest that the authorities should direct export activity by means of tax incentives. It is also important to consider its impact on revenue. Exports of cashew nuts are set to rise in 1994 as large stocks held over from 1992 are run down, so tax revenue may not suffer immediately. But from 1995, there may be some reduction in revenue, increasing the burden on the fiscal position.

The export drive is not limited to cashew nuts. The medium-term scenario envisages rapid growth in exports of other commodities at a rate of nearly 40 percent a year. This seems ambitious, to say the least. From the staff report, it seems that this will concentrate mainly on exports of fish and forestry products. While I accept the remarks made by Ms. Bessone Basto about the need for diversification, it seems that exports of these products would need to be double the highest levels achieved in recent years in order to achieve the exports projection for 1998. Given the evidence of depletion of fish stocks and of deforestation, I wonder whether the staff's medium-term scenario is realistic in this respect. I note that the staff appraisal is quite cautious on this issue.

The financing gaps for future years remain very large. Clearly, significant amounts of assistance and debt rescheduling will be needed. Donors and creditors will be more likely to look favorably on Guinea-Bissau if the authorities can point to a track record of structural adjustment. A Fund-supported program could form part of that adjustment. We hope to see demonstration of successful performance against the informal program and the introduction of structural measures, such as the increase in the tariff on rice imports, before a request for resources is brought to the Board.

I join the staff in encouraging the authorities to take steps to remove exchange restrictions. I welcome the recent developments described in the staff's opening statement and the steps taken to improve the coverage--and extend the availability--of economic data.

Mr. Rainford made the following statement:

Although Guinea-Bissau has made progress under the Fund-monitored macroeconomic and structural reform program for 1993, for which the authorities should be commended, the economy still suffers from fundamental domestic and external imbalances, which call for the implementation of a comprehensive medium-term adjustment program, as Directors recognized at the conclusion of the 1992 Article IV consultation.

The authorities, in their discussions with the staff, have in essence accepted that the economy is suffering from an acute lack of external viability, and are in general prepared to pursue the measures necessary to preserve the vital lifeline now being provided through concessional aid inflows and to facilitate early agreement on a Fund-supported program.

It is clear that the comprehensive medium-term adjustment program required will have to be anchored in sustained and assured flows of concessional balance of payments support and exceptional financing. This is evident from the high level of the ratio of the fiscal deficit to GDP, the extremely high debt-service ratio and the associated large buildup of external arrears to 68 percent of GDP, the continuing large deficit--even with some improvement--in the external current account as well as in the overall external balance, and the uncertain trends in the level of the official reserves.

It is clear from the staff report that these conditions will persist for some time in the future, but the adjustment effort needed will be deserving of international support once the authorities demonstrate serious commitment to a path that will lead the economy, within an appropriate time frame, out of the present fundamental imbalances to a situation of external viability.

In looking forward to the design of an adjustment program, the staff anticipates strengthened efforts on the part of the authorities not only to continue containing current noninterest expenditure in order to improve the primary balance, but also to increase tax revenue to 9 percent of GDP from its current low level of 5 percent of GDP. Given the very low level of per capita incomes in Guinea-Bissau, however, I wonder whether the staff could comment on the nature of the base that would permit a significant increase in tax revenue from its admittedly low current level.

The staff and the authorities--the latter reluctantly--also contemplate, as a revenue-enhancing measure, a doubling of the import tariff on rice from 10 percent to 20 percent. Would this not have an unfavorable impact on the most vulnerable groups in the society and detract from the effectiveness of the social safety net which, it is to be hoped, would be an integral part of the proposed adjustment program? I wonder also whether this would not fly in the face of the worldwide trend, actively supported by the Fund, toward tariff liberalization, and how would this case be distinguished so that it does not become a precedent?

I hope the authorities and the staff will reach an early agreement on a program that could be supported by the Fund.

Mr. Jones made the following statement:

Guinea-Bissau's economic program for 1993 was largely successful. However, the basic conclusion of the staff, namely, that very large macroeconomic imbalances continue to be a major problem, remains valid. There is a clear need to continue the implementation of prudent economic policies, and I welcome the indication in Mr. Santos's opening statement that the authorities are committed to strengthening their adjustment effort. I hope that Guinea-Bissau will soon be in a position to benefit from a Fund-supported program.

Table 12 of the background paper shows--what might be considered an anomaly for an economy such as Guinea-Bissau's--that external grants as a percent of total financing have dropped sharply, from 64.1 percent in 1989 to 40.8 percent in 1992, while loans increased from 29.8 percent to 58.3 percent during the same period. The level of external financing has also been on the decline. One of the adverse effects of the drop in grants, according to the background paper, is that key sectors whose investment had been financed mainly through grants, such as agriculture and industry, saw a reduction in their shares in public investment. Health and education, which are also in dire need of improvement in Guinea-Bissau, have also been affected. The share of investment in health declined from 5 percent in 1989/91 to 1 percent in 1992, and the share of investment in education has remained stagnant. This is happening at a time when infant mortality is very high; doctors are scarce; and the illiteracy rate is high. It is to be hoped, as the reform effort takes hold, there will be an increase in the flow of concessional aid, particularly to these areas as a means of helping to raise productivity. The country will also benefit from substantial debt relief.

A longer-term adjustment effort is needed in Guinea-Bissau, given the importance of promoting economic diversification to make the economy less vulnerable to negative terms of trade shocks. Experience shows that when it comes to economic diversification, this is easier said than done. Thus far, only limited progress has been made in promoting the main alternative exports, fish and wood products. In the staff's medium-term scenario, a significant increase in non-cashew nut exports, from 14 percent of total exports in 1993 to about 39 percent in 1997/98, is considered an important part of the effort to further reduce the current account deficit. I wonder how the adjustment strategy will be affected if this outcome is not achieved.

The staff representative from the African Department recalled that a number of Directors had stressed the need to focus future fiscal consolidation efforts on revenue-enhancing measures. While the staff fully agreed with that assessment, it was important to note that, for 1994 and beyond, most of the revenue-enhancing measures would aim at improving tax administration, rather than introducing new taxes. As the background paper noted, Guinea-Bissau currently had a particularly large number of different taxes for a small economy. Thus, the authorities hoped to simplify the tax system and enhance the effectiveness of tax administration with Fund technical assistance.

While the staff did not support increasing tariffs as a general policy, the proposal to increase the import tariff on rice from 10 percent to 20 percent by the end of 1994 was considered a reasonable, good second-best alternative to raise revenues. As rice was the most widely consumed food product in Guinea-Bissau, the proposed increase in the import tariff would be relatively easy to administer, and it was expected to provide an increase in revenue of about 0.5 percent of GDP on an annual basis. As the domestic price of rice had risen in line with the threefold depreciation of the Guinea-Bissau peso (in local currency terms) that had taken place over the past two years without significant social repercussions, the proposed increase in the import tariff was not expected to have an appreciable adverse impact on the most vulnerable groups.

As Directors had noted, the very high investment/GDP ratio in Guinea-Bissau gave rise to questions about whether the current composition of investment reflected donor preferences, rather than those of the authorities, the staff representative said. Experience showed that donors had relatively more influence in newly independent countries, such as Guinea-Bissau, where the authorities were less experienced in formulating full-fledged investment programs. In such cases, it was important for the World Bank to take a more active role in helping the authorities to carefully screen development proposals and the composition of investment with a view toward enhancing the effectiveness of investment.

The export projections for fish, forestry, and other nontraditional exports might appear to be overly ambitious in terms of unprocessed goods, the staff representative stated. However, a good deal of the projected expansion in exports was to be derived from significant increases in value added, as the country moved toward exporting more goods in processed form. For example, the various tax proposals aimed at promoting the processing of logs domestically could contribute significantly to the value added of forestry products over the medium term.

The expected decline in the domestic savings rate for 1994 would follow a better than projected rate in 1993, which was reflected in the marked reduction in the external current account deficit, attributable largely to the Government's expenditure-restraining efforts, the staff representative commented. Thus, the deterioration in the domestic savings rate projected for 1994 was still consistent with the favorable trend expected over the medium term, with further improvements in the fiscal position.

At the time of the Article IV consultation mission, the Guinea-Bissau authorities had been reluctant to make any commitments regarding Guinea-Bissau's entry in the WAMU, because their discussions with other WAMU countries on the policies needed for convergence were still under way, the staff representative continued. However, the authorities had indicated that membership in the CFA franc zone was not a pressing matter at the current juncture. On that basis, they had formulated policies for 1994 on the basis of the current exchange rate regime.

The staff had not attempted to measure movements in the real effective exchange rate for the Guinea-Bissau peso, owing to the statistical problems involved in trying to access price developments in the country, the staff representative went on. The consumer price index, which was currently limited to foodstuffs, beverages, and tobacco did not provide a sufficient basis for the calculation of a real effective exchange rate. However, a multitopic mission in the area of statistics, which was expected to take place in 1994, would focus on efforts to broaden the base of the consumer price index and make it a more reliable indicator of price developments.

Guinea-Bissau had essentially a floating exchange rate mechanism, as most transactions took place in a parallel exchange market, the staff representative added. The authorities intended to maintain the spread between the official and the parallel market exchange rates at the current level of 2 percent pending the full unification of exchange rates. The staff did not expect any insurmountable difficulties to arise in the move toward unification over the coming months, and it intended to discuss a possible timetable for unification during its forthcoming mission to Guinea-Bissau.

As the staff report noted, the envisaged privatization of five public enterprises in 1993 had been delayed owing to the late availability of the required financial evaluation reports, the staff representative from the African Department concluded. However, in discussions with the staff, the authorities had indicated that further delays might arise in the future owing to a number of technical and political problems. Experience in a number of countries suggested that it was often difficult to gather the widespread political support needed to press ahead with enterprise reforms.

Mr. Santos thanked Directors for their comments, which would be conveyed to his authorities. The Guinea-Bissau authorities had clearly made every effort during 1993 to implement adjustment policies under very difficult circumstances. It was regrettable that the timetable of the forthcoming elections had hindered progress toward agreement on a program that could be supported by the ESAF. He hoped that discussions with the staff on a medium-term macroeconomic and structural reform program would resume as quickly as possible.

The economic situation in Guinea-Bissau was expected to remain very difficult in 1994, given the projected decline in the terms of trade, the recession in the modern sector, and uncertainties related to the timing of external assistance, Mr. Santos said. In such circumstances, it would be very difficult to expect economic performance in 1994 to match that attained in 1993. Nevertheless, the authorities intended to continue the firm implementation of the economic program, because they were eager to conclude discussions with the Fund on a medium-term program. Indeed, further delays in the completion of those discussions could entice the authorities to take desperate actions, which would undermine their track record and the progress achieved thus far, in particular with respect to the exchange system and the financial sector reforms.

In that context, Mr. Santos commented, it was encouraging to note that, while Directors recognized that slippages had occurred and that much remained to be done--in particular with respect to improving revenue performance and accelerating the privatization program--they had encouraged the authorities to make every effort to complete discussions with the staff on a program that would warrant Fund support.

The Acting Chairman made the following summing up:

> Executive Directors noted the progress made by the authorities since the last Article IV consultation in implementing policies aimed at redressing Guinea-Bissau's very difficult economic and financial situation. Successful efforts were made under the staff-monitored program for 1993 to slow monetary expansion and reduce exchange rate distortions, which led to a pronounced deceleration in the rate of inflation, as well as a

marked narrowing of the external current account deficit, despite a reversal in the terms of trade.

Directors, nevertheless, underscored that large macroeconomic imbalances remained. These called for the pursuit of tight budget and monetary policies, coupled with bold structural measures, so that Guinea-Bissau could achieve satisfactory growth, export diversification and, eventually, external viability.

In the fiscal policy area, Directors stressed the need for a significant effort to raise revenues; in that context, the authorities should collect tax arrears, augment receipts from rice imports, and reinforce tax administration. At the same time, it was important to continue to strictly limit the increase in the government wage bill, maintain tight control over other current outlays, halt net lending, and restrain capital spending. Several Directors expressed concern about the relative ineffectiveness of government capital outlays, and encouraged the authorities to give such investments closer scrutiny. To complement sustained fiscal consolidation, Directors considered that a further tightening of the monetary and credit policy stance was warranted, and for this purpose interest rates should be maintained at positive real levels. Directors recommended that the authorities move speedily to complete unification of the exchange system.

As for structural measures, Directors welcomed the emphasis placed by the authorities on civil service and public enterprise reforms. Regarding the latter, the authorities were encouraged to step up the process of privatization of public enterprises, and, in parallel, to establish a well-defined plan for settling all enterprise cross-debts and other overdue financial claims.

Directors expressed concern about Guinea-Bissau's heavy external debt-service obligations, and emphasized the consequent need for the authorities to seek new financial assistance only on highly concessional terms. They noted that the country would also require very substantial debt relief to bring debt-service obligations to manageable levels. To mobilize such exceptional assistance from the international community, the authorities needed to build on the progress achieved in 1993 in order to establish a strong record of comprehensive and sustained adjustment measures, and move to a Fund-supported program as soon as possible.

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

4. <u>GUYANA - 1993 ARTICLE IV CONSULTATION</u>

The Executive Directors considered the staff report for the 1993 Article IV consultation with Guyana (SM/94/37, 2/9/94). They also had before them a background paper on recent economic developments in Guyana (SM/94/44, 2/18/94).

Mr. Kafka made the following statement:

My Guyanese authorities wish to express their gratitude to the staff for the support manifested and suggestions made during the recent Article IV consultation. Guyana has greatly strengthened its public finances and made important progress in domestic and trade liberalization. The establishment in 1991 of a market-determined exchange rate has encouraged the growth of exports and resulted in a major improvement in the level of foreign exchange reserves. Renewed confidence in the macroeconomic framework and the establishment of positive real interest rates appear to have increased private sector savings and attracted capital inflows. My authorities are committed to intensifying their adjustment efforts and to building on the progress achieved in reducing the rate of inflation and advancing economic recovery in the context of a successor arrangement to the ESAF. As an indication of their resolve to promote private sector development, a privatization unit (PU) has been established to prioritize and prepare public entities for divestment.

Guyana continued to meet the indicative targets under the Fund-supported program with large margins. Real GDP growth of over 7 percent for 1993 reflects the fruition of large private investment projects in timber and gold, a sharp recovery of bauxite production, and a continued increase in rice production stemming from the liberalization of price and marketing arrangements. In addition, two large foreign-owned companies have undertaken considerable investment in the harvesting of forestry resources on a sustainable basis.

Tight macroeconomic management, coupled with continued relative stability in the exchange rate, allowed the rate of inflation to decline to below 10 percent by end-1993.

The overall public sector deficit has continued to narrow from 45 percent of GDP in 1991 to an estimated 32.5 percent in 1993. The considerable strengthening of the fiscal position reflects an increase in tax revenue, a tight control of non-interest expenditures, and a decline in interest obligations. The latter results from a decline in domestic interest rates, a contraction in the stock of domestic debt, and external debt write-offs.

In 1994, my authorities will continue to streamline the public sector in line with the recommendations of the multilateral financial institutions and overseas development agencies of donor countries, in the context of their objective to ensure good management. With respect to the electricity company (GEC), collection efforts have been improved, the second round of tariff increases was implemented in January 1994, and additional generation capacity will be in place shortly. Also, my authorities are in active negotiations with the Inter-American Development Bank (IDB) on measures to improve management in the short term and to analyze the scope of feasible options for the medium term.

My authorities have implemented the first phase in the reduction of tariffs under the Common External Tariff (CET) and will seek to offset projected revenue losses by revenue measures to be adopted in the 1994 budget.

In the monetary sector, the lowering of the public sector deficit and the accompanying contraction of domestic credit to the public sector have facilitated a sharp growth in credit to the private sector. This has been done in the context of a tight monetary stance maintained by the Bank of Guyana (BoG). In 1994, the BoG is seeking to enhance further, with Fund technical assistance, treasury bill auctions and complement its capacity to reduce, or absorb, excess liquidity.

My authorities recognize that the existence of a viable financial sector is critical to sustained economic growth. The financial system will be strengthened by the enactment of the Financial Institutions Act (FIA), expected before the middle of this year, which will enable the BoG to exercise greater regulatory and supervisory control over the banking system. To supplement the financial liberalization process, the Government's participation in this sector will be reduced through restructuring and privatization of government-owned financial institutions. Recently the World Bank, the IDB, and the Government have agreed--in principle--as part of a Private Sector Development Credit lending operation under discussion, to merge the development bank (GAIBANK) and the Guyana National Cooperative Bank (GNCB) and restructure the new institution.

Under the auspices of the PU, my authorities will privatize this year: Guyana Stores, Guyana National Engineering Corporation, the Guysuco Dairy Complex, and its remaining shares in the Guyana Bank for Trade and Industry. A further four public entities will be prepared and identified later on for privatization in 1995. To encourage greater distribution of equity in the divestment process, plans are afoot to facilitate worker participation through Employee Stock Ownership Plans (ESOPs). Also, as part of the overall process of facilitating capital market development, my authorities have recently established a call exchange at the BoG as a precursor to a stock exchange.

The staff report outlines the favorable reaction to the Government's policy statements at a recent meeting of the Caribbean Group for Cooperation in Economic Development (CGCED). My authorities appreciate the support given by donor countries represented at this Board. In combination with increased domestic savings, this support remains vital for the sustainability and success of Guyana's structural adjustment program.

The staff report indicates, and my authorities concur, that Guyana's external position remains vulnerable over the medium term. Guyana's cumulative financing needs are lower by US$260 million than they were at the previous discussion, and the projected financing gap over the period 1995-2000 amounts to US$195 million. My authorities recognize that there are formidable challenges in the alleviation of poverty, renewing deficient infrastructure, improving the efficiency of the public sector, and eliminating the debt overhang. They intend to work closely with the staff to continue pursuing appropriate policies to allow Guyana to achieve sustainable growth. We look forward to the support of this Board when the negotiations on a program to be supported by the successor to the ESAF successor have been completed.

Mr. Dorrington made the following statement:

My impression of developments in Guyana has not changed since the midterm review of progress under the enhanced structural adjustment arrangement in October 1993. Guyana's overall macroeconomic policy performance continues to be very good, but structural reforms are still lagging behind. As time goes on, I am increasingly concerned about whether a failure to speed up structural reforms, particularly privatization, will begin to put Guyana's admirable achievements under the Economic Recovery Program at risk. It will certainly limit the benefits to be derived from the macroeconomic measures. This reminds me of a pair of scissors with one blade being kept very sharp, but the other remaining blunt.

I will not dwell on the fiscal side, which seems to be going very well. I am impressed by the progress made on strengthening revenues, both through reform of the tax regime and through improvements in tax administration, although there have been some delays in the latter. I trust this good work will continue. I am glad to see that current expenditure has declined as a proportion of GDP, although I agree with the staff that the Government will need to maintain tight control, especially over public sector wages. In this context, I am pleased to note that the World Bank's Public Administration Project is finally under way.

As to the structural reform effort, the need for Guyana to press ahead with privatization is clear. The benefits are three-fold. First, privatization will relieve the Government of its heavy public enterprise burden. In some cases, such as the GEC, enterprises are already operating at a loss. Others may soon do so. In addition, the operating surpluses of the smaller public enterprises are estimated to have fallen dramatically, by 3.5 percent of GDP, since 1992. This certainly underlines the urgency of the situation. Second, privatization is likely to lead to improved performance. Third, and perhaps most important, pressing ahead with privatization will help give investors the confidence to bring more private money into Guyana--something that the economy badly needs.

Therefore, the statement by the President of Guyana at the recent meeting of the CGCED that four enterprises would be privatized this year was encouraging. In addition to these four specific cases, Mr. Kafka indicated in his opening statement that a further four privatizations are planned for next year. I hope it will not be long before these statements evolve into a clear and comprehensive privatization timetable. I wonder whether the staff or Mr. Kafka could comment on when such a timetable might be published. There is an obvious opportunity here for the Government to demonstrate that it can make bold structural plans and stick to them, as they have already demonstrated in the macro-economic area. It is also vital that the authorities do not allow room for uncertainty about their intentions by appearing to back-track, as appeared to be the case in the President's speech earlier this month to the sugar workers' union.

The GEC remains a millstone around the Government's neck. It is regrettable that there has still been no agreement on the management contract that was to have been in place this month. The GEC badly needs expert help to get it out of its current downward spiral. I strongly agree with the staff on the need for a further tariff increase this year. The GEC seems to be descending into crisis: the staff's report of increased blackouts owing to failure to put sufficient resources into maintenance and repair is deeply worrying. The lack of a reliable power supply is surely one of the greatest deterrents to potential investors.

With respect to Guyana Airways, in most circumstances, for a relatively small company like this, I would question the justification for undertaking many functions in-house, rather than contracting them out. When doing so is actually leading to losses, I find the justification even more difficult.

As to financial sector policies, I warmly welcome the establishment of the call exchange, which I hope will make a real contribution to the development of financial markets in Guyana. I am also pleased to note that the new FIA has Cabinet approval, and

I look forward to its enactment. I hope this will be sooner, along the lines of the staff's expectation of early 1994, rather than later, as Mr. Kafka's projection for mid-1994 suggests.

I note that a staff team will leave soon to begin negotiations on a successor program to the current ESAF arrangement. There is no doubt about the need for a further program: there is much remaining on the structural adjustment agenda, and a balance of payments need certainly exists. The design of the successor program will need to take account of the strengths and weaknesses of Guyana's performance over the past year or two. While it will be necessary to ensure continued good macroeconomic policy performance, the focus of the program must be to sharpen the structural reforms. As the Board has indicated on many previous occasions, the targets should be ambitious but realistic. The Government must be committed to achieving them. In winning back investor confidence, Guyana will do better to set realistic targets and meet them, than to make a splash with overambitious proposals which they then fail to implement. Table 3 of the staff report clearly demonstrates how much catching up is needed. In particular, no time can be wasted in improving the GEC. I hope that some real progress is made on a number of the delayed reforms before the new program is brought to the Board.

If some of my comments for the current discussion seem harsh, this is a reflection of frustration more than anything else. If the performance on structural measures matched the fiscal performance, the outlook would be much brighter.

Finally, I fully support the staff and Government calls for help to relieve Guyana's debt. I hope the Paris Club will do all it can when it considers restructuring Guyana's stock of debt; and that the slight delay in agreement to a successor program supported by the Fund will not prove to be an obstacle. Nevertheless, given the high proportions of multilateral and commercial debt in Guyana's portfolio, there is a limit to what the Paris Club can do. Guyana's real hope lies in encouraging more private investment, and--as a prerequisite--for the Government to leave no room for doubt about its commitment to private sector-led growth.

Mr. Rainford made the following statement:

Overall, the staff report gives cause for encouragement. 1993 was the third consecutive year of relatively strong real GDP growth, continued stabilization of prices, and strengthened official reserves, following the very steep decline in output and erosion of the infrastructural base of the economy during the 1980s. The turnaround has stemmed from the implementation of confidence-building measures by the authorities in the context of reasonably well-orchestrated international assistance anchored in an adjustment program supported by stand-by and ESAF arrangements.

There seem to be grounds for concluding, albeit with caution, that the economic decline in Guyana has indeed bottomed out and that, on the basis of continuing international support and sound policies by the authorities, the recovery should continue to the point of takeoff into self-sustained growth. With Guyana's considerable potential in agriculture, mining, forestry, fisheries, tourism, and perhaps eventually in manufacturing, the authorities are urged to maintain appropriate policies and to strengthen them where necessary in order to reach this goal.

Accordingly, the authorities are to be commended for achieving, with comfortable margins, all the quantitative benchmarks in the 1993 program supported by the ESAF and for making further progress in various areas of structural reform. However, I agree with the staff that the authorities face a need for more decisive action on certain strategic fronts if the momentum of recovery is to be maintained. I will comment briefly on just three of these areas.

First, with divestment having taken place with respect to 14 public enterprises along with other government interests during the two years up to October 1992, and none since then, there is reason to be concerned about an apparent pause in the implementation of the privatization program. The uncertainty is relieved somewhat by the release by the Government in July 1993 of a privatization strategy paper and the more recent earmarking by the authorities of four enterprises for divestment in 1994 and another four in 1995. However, a question remains concerning whether this is an adequate pace for the privatization process, even making allowance for thorough preparation and careful negotiations. The concern arises from the practical consideration that the injection of equity and management resources from outside the Government into the public enterprises is critical in helping to maintain growth, and would free up the limited capacities within the public sector to focus on policy planning and implementation, construction and maintenance of the macroeconomic and regulatory framework, and the building up of the physical and social infrastructure.

Second, the GEC is not just another public enterprise, but one whose operations affects the tempo of most of the economy. The GEC needs not only to balance its finances, but also--and more critically--to overcome the perennial outages that characterize its supply of power. Therefore, the reduced deficit of the GEC for 1993 indicated in the staff report is a mixed blessing, if a blessing at all, as it is the result of insufficient outlay on maintenance and repairs which, in turn, is linked to the outages the country has been suffering. I join the staff in urging the authorities to ensure maximum benefit from the assistance being provided by the IDB in this area, to move quickly to put the required management arrangements in place, and to reduce the present high level of loss of power that is actually generated. I wonder whether the scope for generating hydroelectricity was reviewed with the authorities and what is the current outlook on this.

Third, the difficulties of the public service could become a serious constraint on the future growth of the economy. Even with the recent public sector wage increases in 1992 and 1993, strategic high level personnel are being lost rather than attracted to the public service.

The staff has stated, with good reason, that the fiscal stance for the foreseeable future must involve tight containment of noninterest current outlays, including wages, in order to compensate for weakening performance of the public enterprise sector and to make room for increased capital expenditure. The dilemma is that, in order to have a public service in Guyana effectively performing the functions expected of it, compensation packages need to be improved, either generally or selectively. I wonder whether this can be achieved within the present level of expenditure on wages by a combination of downsizing the service and implementing the Public Administration Project that the World Bank has approved for Guyana.

The Guyanese authorities have indicated their desire to have a successor program to the enhanced structural adjustment arrangement that has just ended. Their performance under this first arrangement and the remaining challenges ahead make a successor arrangement highly appropriate. It will give Guyana the opportunity to explicitly specify and pursue polices on which future international assistance can be anchored, including, critically, further reduction in the debt-service burden, which remains high even after past rescheduling and forgiveness of debt.

Mr. Wang made the following statement:

We commend the authorities for having proceeded with the economic adjustment and reform program supported by the ESAF. Over the past three years, quite impressive progress has been made in correcting macroeconomic imbalances and improving domestic policy setting. Now that the reform process has reached a crucial juncture, these outstanding structural weaknesses need to be addressed. It is heartening to note that the authorities remain committed to pressing ahead with a renewed reform program.

I share many of the views expressed by previous speakers and the staff assessment, and would like to make three brief observations.

First, the unsatisfactory public enterprise performance, together with a delay in the implementation of the privatization process, is a cause for concern. In light of the adverse fiscal implications, the staff is correct that public enterprise restructuring has to be given immediate priority on the authorities' policy agenda. To gradually diminish the monopolistic role of public companies with a view toward enhancing their efficiency and competition, it is better to privatize them at the earliest possible date. Perhaps the public enterprises' lack of entrepreneurship and internal hard budget constraints have to some extent resulted in their running at a loss. In this connection, we are pleased to note from Mr. Kafka's very helpful opening statement that a Privatization Unit has been established to prioritize and prepare public entities for divestment. In addition to privatization, equally serious attention should be given to strengthening the enterprises' internal operating mechanism as a parallel way of addressing their weakened financial position.

Second, the authorities are encouraged to continue their efforts to build up the much-needed infrastructure in the banking and financial sectors. Compelling efforts should be made to nurture the domestic financial markets. This includes instituting a secondary market for treasury bonds and open market operations for the Central Bank, and perfecting an integrated foreign exchange market. In addition, it is crucial to improve the soundness of both the state-owned and private commercial banks through strengthening prudential supervision and regulation.

Third, the staff's medium-term outlook for Guyana illustrates that there will be a persistent financing gap and its debt and debt-servicing obligations remain a cause for concern. Given the authorities' encouraging policy performance and bold implementation of the consistent economic adjustment and reform program, and in light of the difficult economic outlook ahead, we would stress the importance and necessity of redoubling the Government's efforts to achieve their ultimate goal of transforming to a market-oriented economy. At this critical juncture, it is imperative not to abandon the adjustment process which has borne fruit as the authorities are just halfway toward their objectives. Therefore, we would welcome a discussion on an ESAF successor program for Guyana.

Mr. Ryan made the following statement:

As the staff report observes, Guyana continues to experience the benefits of adhering to the Economic Recovery Program. GDP growth remains strong, the rate of inflation continues to decline, the external accounts show improvement, and public sector deficits have declined. Unfortunately, the authorities do not appear to be taking the initiative to build on the Economic Recovery Program blueprint in order to make more decisive progress to reduce government involvement in the economy, boost domestic savings, and attract needed foreign investment.

Guyana is a well-endowed country that should be doing better than it is. With one of the highest per capita levels of external debt in the world, a greater sense of urgency by the authorities is needed to signal foreign investors, the donor community, and creditors that the Government is committed to moving the reform process ahead. The staff report points out some good places to start. The GEC is an inefficient drain on the budget as well as a drag on the economy. The action plan supported by the IDB ought to be accepted and privatization made a near-term objective. The process of privatization and public enterprise reform in general needs to be sped up. We are pleased to note the establishment of a privatization unit and modest plans for divestment in 1994, but this process has been rather slow, to say the least. A clearer plan of action is needed.

Accelerated progress on privatization would generate one-time revenues that might help pay down the stock of debt, as well as reduce sources of net budgetary transfers. Greater efficiencies would be realized and needed foreign investment would be attracted. As the staff report notes, overseas investors are taking a "wait-and-see" attitude toward Guyana at the moment owing to questions about the commitment of the authorities to market-led growth. Moreover, it appears that substantial amounts of multilateral lending could be unlocked by greater action by the Government in this area.

Given Guyana's investment needs, domestic savings need to be increased in order for the projected decline in current account deficits to occur over time. As already suggested, privatizations, in addition to removing some sources of dissavings, would generate opportunities for additional savings as new investment potential is freed up. Measures to strengthen the financial sector and improve the intermediation process, including enactment of the FIA, are also important in this respect--as are steps to expand and deepen competition among banks. For some time now, the licensing of private banks has been promised, but postponed.

Efforts to scale back the central government deficit will be an ongoing task. The current account primary surplus of the Central Government has increased rather substantially over the past two years, but the overall primary surplus as a share of GDP has not shown similar improvement. Most of the improvement in the overall budget deficit over the past few years has been due to declines in interest rates, rising current revenues, and less capital spending. Noninterest current expenditures have made a relatively modest contribution to the improvement. Recent wage increases point to the need for increased attention to possibilities for better rationalization of the civil service and more selective appreciation of real wage increases.

All in all, Guyana has come a good distance from the disastrous policies and conditions in the 1980s, but needs to re-energize its efforts if it is to move ahead and more fully realize its economy's potential.

Mr. Desruelle made the following statement:

Like previous speakers, I would like to acknowledge the continued improvement of the macroeconomic situation of Guyana. Combined with the progress already made in the previous two years, there is no doubt that much has been accomplished throughout the ESAF program.

At the last meeting of the Caribbean Group for Cooperation in Economic Development, the authorities indicated their intention to keep following the path of reform. This is a welcome development, as is the authorities' desire for a new enhanced structural adjustment arrangement.

In this framework, I will comment briefly on fiscal policy and structural reforms.

First, the reduction in the overall deficit of the public sector has been an important element favoring macroeconomic stabilization. Therefore, it is very appropriate that it should continue to decrease, as is projected for 1994. At the same time, there seems to be a definite need for higher spending on basic infrastructure and on health and education, even after taking into account the progress made in 1993 in that area and the increased role that could be taken by the private sector in these areas.

To achieve jointly these two results--a decrease in the overall deficit and a shift toward infrastructure and social spending--will require determined efforts. This is all the more true, given the many factors that could adversely affect the fiscal situation, such as the weakness of public enterprises and the cost of restructuring the banking sector.

The area that holds the best promise for fiscal improvement seems to be the improvement of tax administration. Progress on that front has been much slower than anticipated during the last enhanced structural adjustment arrangement. I wonder whether the staff could comment on that and on measures that could be taken to speed up such progress. With respect to the shift in spending, I also wonder whether the staff could comment on how much emphasis should be given to infrastructure and social spending.

I fully agree with previous speakers that further privatization and reform of public enterprises have to be a priority. In this respect, the establishment of a privatization unit and the announcement of a list of four enterprises to be privatized in 1994 are, after the absence of any privatization since October 1992, very positive steps. Beyond these planned privatizations, which should be realized without unnecessary delays, efforts to restructure and to privatize part of the financial system and to address the difficulties of the major nonfinancial public enterprises should be forcefully pursued.

Appendix II of the staff report indicates that Fund technical assistance to Guyana has focused on two areas, statistics and monetary affairs. Technical assistance in the statistical area is obviously of great benefit. Appendix IV of the background paper shows both the great needs of the Guyanese authorities in that area and the quality of the assistance provided by the Fund. At the same time, technical assistance on monetary affairs, or more precisely the extent of it--one mission in 1993 plus two advisors at the central bank--raises some questions. The delicate state of the financial system requires thorough analysis and attention; and a logical division of labor between international agencies in technical assistance gives the Fund the lead in monetary affairs. Nevertheless, I wonder whether the extent of technical assistance in that area does not reflect the fact that the monetary management system that the authorities have been advised to implement is too elaborate for the needs and the implementation capacity of the country. It is important to bear in mind that Guyana has a population of only 760,000, a financial system dominated by five commercial banks, a per capita GDP of $370, and a scarcity of human capital commensurate with that GDP figure. Therefore, technical assistance that puts emphasis on further improvement of the treasury bill tenders, on development of a secondary market and of open-market operations might be akin to asking the authorities to build a Formula One Grand Prix racing car when a good, sturdy station wagon would do very well. Could we not save--in the sense of being able to relocate to other areas in need of great attention--precious resources of both Guyana and the Fund by advocating simpler but still effective financial programming instruments?

With these comments, I look forward to consideration of a strong program to be supported by the ESAF.

Mr. Moss made the following statement:

> At this stage of the discussion, I will focus my comments on two aspects of Guyana's economic outlook, the fiscal position and wage developments.
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> I join the staff and previous speakers in urging the authorities to press ahead with privatization and public enterprise reform. Not only is such action needed to attain the budgetary objective for this year, but it is also required to create the means of funding a possible recapitalization of certain public banks--an issue indirectly referred to in Mr. Kafka's opening statement. Moreover, a less negative operating balance for the public enterprise sector will enable the Government to start contemplating tax reductions over the medium term. Indeed, revenue-enhancing measures have been very successful in Guyana, but by the same token this has lifted the current revenue to GDP ratio to over the 50 percent threshold. Such a figure seems to be on the high side in a regional perspective and might start hampering growth over the medium term. I wonder whether the staff could comment on this issue.
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> As the background paper notes, one of the reasons for the rapid rise of tax receipts concerns the strong growth in personal tax collections in the wake of buoyant real wage growth. Of course, real wages in the public sector were cut in half over the period 1988-91, making the subsequent recovery by some 18 percent less alarming. However, the background paper also notes the existence of a wage spiral for skilled labor in some sectors, prompting the question of how the authorities are going to address the wage issue, especially once privatization starts taking hold. Mr. Rainford and Mr. Ryan have also touched on this issue, and I look forward to the staff's or Mr. Kafka's comments.

The staff representative from the Western Hemisphere Department recalled that, at a donors' meeting of the CGCED in January 1994, the Guyanese authorities had made a commitment to privatize four enterprises in 1994 and another four in 1995. However, at subsequent meetings with the World Bank and the IDB, the authorities indicated that they intend to press ahead with moves to privatize other public sector enterprises as well.

Moreover, plans were under way to restructure the three largest public sector enterprises, the staff representative continued. When the first stage of the two-phase strategy developed with World Bank assistance to prepare the bauxite company, LIMINE, for privatization was completed in May 1994, an investment banker would be asked to prepare a prospectus on the company. Also as part of a World Bank project, an investment banker was expected to be appointed in mid-1994 to prepare a prospectus on the sugar company, GUYSUCO. The authorities were currently holding discussions with the IDB on a long-term strategy to improve the operations of the GEC. That strategy would include opening up the company to private sector participation possibly in 1995. The staff hoped that agreement on a clear timetable for the privatization program could be reached in the context of the forthcoming discussions on a successor arrangement to the ESAF.

The decrease in central government current expenditures had been borne primarily by spending cuts on wages and on other goods and services, the staff representative noted. In the period 1989-93, expenditures on other goods and services had declined from 13 percent of GDP to 9 percent of GDP. Following a sharp decrease in 1989-91, real wages for the public service had increased by about 8 percent in 1992 and 9 percent in 1993, which was in line with the program targets. It should be noted the revisions in public service wages reflected across-the-board increases that did not allow for selective wage adjustments.

The World Bank Public Administration Project provided for selective wage increases aimed at attracting and retaining highly skilled personnel, the staff representative said. It also provided for cash incentives for workers returning to Guyana. The wage supplements--amounting to US$10,000 for workers returning to Guyana and an additional US$15,000 upon three years of service--were not large, but they could help to attract some repatriation of skilled labor.

In addition to the 8-9 percent increase in real wages that had taken place over the past two years, an additional increase of about 5-6 percent was expected in the coming years, the staff representative stated. The increase in the level of real wages together with improvements in infrastructure, in particular with respect to health and education, should help attract skilled workers to Guyana.

The substantial expenditure cuts in other goods and services had rendered some parts of the public service all but inoperative, as they could afford spending only for wages, the staff representative commented. The authorities hoped that a reduction of transfers to public sector enterprises, such as the GEC, would allow for increased spending in other important areas of the public service.

With respect to the operations of the GEC, it should be noted that testing had begun on the new 11 megawatt plant that was expected to be fully operational before the end of March 1994, the staff representative continued. In addition, a 9 megawatt turbine that had been sent to the United States for repairs was expected to be back in operation by the end of March. The arrangements to put in place an interim management team for the GEC were expected to be completed in the next week. Once the new general manager was appointed, a consultant would also be put in place possibly by the end of April 1994.

Although the FIA had been temporarily withdrawn from parliamentary consideration for technical reasons, it was expected to be submitted to Parliament again for approval, it was hoped before April 1994, the staff representative said. Although the work related to amending the Bank of

Guyana Act was well under way, it had not yet reached a stage that would allow targeting a date for Parliamentary approval. The consideration of three applications for commercial bank licenses had been delayed, owing to some difficulties encountered by the authorities in obtaining additional information needed to substantiate the applications. Nevertheless, the authorities hoped to finish processing those applications in the coming two to three months.

With assistance from the IDB, the authorities were making concerted efforts to improve tax administration, the staff representative stated. While the project supported by the IDB was put in place last year, following a delay of more than two years, there was a need to redefine its terms of reference in the light of recent developments. Nevertheless, the increase in current revenues from 35.5 percent of GDP in 1992 to 40.5 percent in 1993 was partly attributable to improved collections and, in particular, to improvements in the tax administration in the Customs and Excise Department. The 1994 budget included measures to continue the expansion of the tax base and to reduce the high rate of taxation, although some of those measures may result in increased tax evasion.

With respect to tax administration, it was important to note that the ratio of revenue to GDP appeared to be very high, partly owing to the underestimation of GDP, the staff representative continued. Thus, there was a need to focus more on how the variables moved over time, rather than on absolute amounts. As efforts were under way to improve the collection of economic data, the staff hoped to have better information on the national income accounts by the time a successor arrangement under the ESAF was brought to the Board.

The sharp decline in interest rates had helped to stabilize the exchange rate, increase private sector confidence, and establish a climate conducive to further adjustment efforts, the staff representative considered. The measures currently under consideration are aimed at increasing competition within the banking sector in order to reduce the spreads between lending and deposit rates. In addition, the recent establishment of a call exchange should increase the number of transactions and enable the authorities to raise capital without resorting to borrowing. As to the pace of the financial sector reform, it should be noted that the introduction of biweekly treasury bill auctions in January 1994 had proceeded smoothly.

While Fund technical assistance to Guyana seemed to be concentrated primarily in the area of monetary affairs, it should be noted that one of the two advisors currently working with the Bank of Guyana was serving as a general advisor to the Governor of the Bank and the Research Department on a variety of macroeconomic issues, the staff representative commented. The other advisor was working primarily on the financial sector reform, including issues related to banking supervision and the establishment of prudential regulations. It should also be noted that because the banking system had been under the complete control of the Ministry of Finance and the Central Bank for 20-25 years, Guyana currently had almost no instruments of indirect monetary control. In that respect, progress over the past few years, including the establishment of the treasury bill auctions and the call exchange, had exceeded the staff's original expectations.

Other organizations, including the World Bank, the United Nations Development Program, and the IDB were also providing substantial amounts of technical assistance to Guyana, the staff representative from the Western Hemisphere Department said. In the context of the range of technical assistance being provided by the World Bank and the IDB aimed at improving the operations of commercial banks, the development bank, and the national insurance system, the assistance provided by the Fund to the Central Bank helped to maintain the balance needed to effect a comprehensive reform of the financial sector. In the context of discussions on a successor arrangement to the ESAF, the staff would concentrate on the coordination of technical assistance from international organizations and donors.

Mr. Kafka thanked Directors for their comments, which would be conveyed to his Guyanese authorities.

As Directors had noted, Guyana had made great advances in the management of its economy over the past few years, Mr. Kafka stated. While structural changes had been somewhat slow to take effect in Guyana, it was important to note that--aside from the need to overcome technical problems--the pace of reform reflected the authorities' desire to garner strong public support for any change in the structure of the economy. In that respect, although the structural reform of the Guyanese economy had taken time, it was time well spent. Perhaps the case of Guyana could best be described by an old Latin proverb that gave the advice to "hurry carefully."

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal. They commended the authorities for efforts to continue to improve macroeconomic performance during 1993, but they expressed disappointment at the lagging pace of structural reforms--particularly in the public enterprise area which, unless corrected soon, could begin to put at risk the hard-won gains in the macroeconomic field. With the strengthening of the public finances, the rate of inflation had moderated further, the exchange rate had remained relatively stable, and the level of international reserves had increased substantially, while the recovery in economic activity had continued. Directors welcomed Guyana's satisfactory performance under the enhanced structural adjustment arrangement that expired on December 20, 1993.
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> Directors noted that the fiscal plan for 1994 envisaged a further improvement in performance. While Directors supported the authorities' plans to further strengthen tax administration, they stressed that a reduction of tax exemptions and continued restraint over noninterest current outlays, including wages, would be required. Directors urged early action on privatization, and

welcomed the authorities' intention to privatize four enterprises during 1994, and another four during 1995.

Directors stressed that much remains to be done in restructuring the largest public enterprises, and they expressed concern about the weakening in the position of the smaller entities. They noted that financing of the required substantial capital outlays in the sugar and bauxite industries would need to rely on private investment, and urged the authorities to consider early privatization of these enterprises. Directors were disappointed by the lack of further progress in addressing the problems of the GEC, and noted the need to strengthen the GEC's management and to raise electricity tariffs to attain long-term sustainability.

Directors welcomed the progress in financial sector reform, including Cabinet approval of a new banking act, the move to more frequent treasury bill auctions, and the establishment of a call exchange to facilitate stock trading. Directors noted that a firm monetary policy stance was required to consolidate Guyana's progress in moderating the rate of inflation. They encouraged the Government to further strengthen the Central Bank's capacity to manage short-term liquidity.

To continue to make further progress toward viability over the medium term, Directors emphasized the need for further strengthening of the public finances beyond 1994. Notwithstanding the gains achieved to date, Guyana will continue to face heavy debt-servicing obligations over the medium term. Accordingly, they were encouraged by the Paris Club's commitment to consider restructuring Guyana's stock of debt. To strengthen Guyana's growth prospects, Directors emphasized the paramount need to encourage private sector activity and to downsize the public sector. In this context, Directors noted the intention of the authorities to request an arrangement supported by the ESAF successor.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/94/15 (2/25/94) and EBM/94/16 (2/28/94).

5. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - POSTPONEMENT OF POST-INELIGIBILITY REVIEW

The review of Liberia's overdue financial obligations to the Fund provided for under paragraph 5 of Decision No. 9396-(90/50), adopted March 30, 1990, as amended, is postponed to a date to be determined by the Managing Director, when, in his judgment, there is once again a basis for evaluating Liberia's economic and financial situation, the stance of economic policies, and its cooperation with the Fund, and in any event not later than August 27, 1994. (EBS/94/31, 2/23/94)

Decision No. 10600-(94/16), adopted
February 25, 1994

APPROVAL: August 19, 1994

LEO VAN HOUTVEN
Secretary