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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/105

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

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	L. E. N. Fernando
	Deng H., Temporary
C. S. Clark	
T. C. Dawson	Q. M. Krosby
	S. B. Creane, Temporary
	J. Prader
	B. Szombati, Temporary
E. A. Evans	
R. Filosa	
M. Finaish	A. F. Mohammed
	J. A. Solheim
	M. Nakagawa, Temporary
	B. Esdar
J. E. Ismael	T. Sirivedhin
	J. C. Jaramillo
J.-P. Landau	P. Bonzom, Temporary
	H. Dognin, Temporary
	O. Kabbaj
	L. J. Mwananshiku
	P. Wright
G. A. Posthumus	
	Y.-M. T. Koissy
	J. K. Orleans-Lindsay, Temporary
	M. Galán, Temporary
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
B. R. Burton, Assistant

Also Present

IBRD: K. Dervis, Europe and Central Asia Regional Office. European I Department: M. Russo, Director; J. Artus, Deputy Director; M. C. Deppler, Deputy Director; M. Mecagani, M. H. Rodlauer, R Sahay, A. Singh. External Relations Department: S. J. Anjaria, Director; M. Seeger. Fiscal Affairs Department: S. K. Chand, B. J. Clements, L. U. Figliuoli. Monetary and Exchange Affairs Department: H. Mehran, M. J. Nieto. Policy Development and Review Department: J. Boorman, Director; T. Leddy, Deputy Director; M. Shadman. Secretary's Department: A. Jbili, A. Leipold. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; J. E. Blalock, R. F. Cippa, E. Decarli, L. U. Ecevit, D. K. Kar, K. M. Kenney. Office of the Managing Director: P. R. Narvekar, Special Advisor to the Managing Director; B. P. A. Andrews, Personal Assistant to the Managing Director. Advisors to Executive Directors: M. A. Ahmed, G. Earp, B. R. Fuleihan, Y.-H. Lee, S. von Stenglin. Assistants to Executive Directors: B. Abdullah, S. E. Al-Huseini, M. C. Arraes Vinhos, B. Bossone, J. H. Brits, B. Eggl, N. A. Espenilla, Jr., H. Golriz, K. M. Heinonen, J. Jonas, T. Kanada, Kudiwu T.-M., V. Kural, K. J. Langdon, W. Laux, J. Mafararikwa, L. F. Ochoa, E. H. Pedersen, E. Quattrociocche, F. A. Sorokos, D. Sparkes, T. P. Thomas, Tin Win.

1. LIQUIDITY POSITION AND FINANCING NEEDS - REVIEW

The Executive Directors considered a staff paper on the Fund's liquidity and financing needs (EBS/92/128, 8/7/92).

Mr. Clark said that the staff's upward revision of the Fund's liquidity position projected for end-1992 was cold comfort, because the decline in the liquidity ratio to 50 percent largely reflected delays in the conclusion and timing of arrangements and the subsequent shifting of demand for Fund resources to 1993. The inference was that the Fund's liquidity position would deteriorate by more than was notionally projected for 1993, even without an increase in demand for Fund resources by the former Soviet republics. Moreover, the staff's projection made no allowance for the possible accumulation of further arrears. Therefore, despite the upward revision to the Fund's liquidity position, its projected deteriorating trend was still of great concern, and the increase under the Ninth General Review of Quotas needed to be implemented urgently. In that connection, recent developments were encouraging. He urged the countries that had not yet approved the quota increase to complete their task as quickly as possible. In addition to alleviating Directors' concerns about the Fund's ability to carry out its mandate fully, approval of the Ninth General Review of Quotas would ensure that Directors would soon be able to review the existing policy on access.

Mr. Dawson noted that the staff paper highlighted the adequacy of the Fund's liquidity for the remainder of the year. The demand for Fund resources had been moderate in 1992, particularly in net terms. The staff's point that that moderation in demand did not reflect a long-term downward shift in the demand for resources, but was largely due to a deferral of previously anticipated resource claims, was well taken. He agreed that prompt implementation of the quota increases under the Ninth General Review was needed to secure the Fund's ability to meet resource needs over the medium term. His authorities were making every effort to achieve prompt passage of the necessary legislation, which was expected after Congress returned from vacation on September 9, 1992.

He did not agree that urgent consideration of alternative financing actions was needed, Mr. Dawson remarked. The 83 percent liquidity ratio was comfortable. The projected decline to 50 percent by year-end rested on the assumption of a sharp increase in demand over the remainder of 1992, far exceeding that of the first seven months of the year, and reflected the conservative methodology used by the Treasurer's Department in estimating the liquidity ratio. In short, the Fund's liquidity was adequate for the period immediately ahead, and implementation of the quota increase would enable it to meet the challenges of the 1990s.

Mr. Ismael made the following statement:

> I broadly agree with the staff's concluding observations on the Fund's liquidity position and financing needs. It is a serious cause for concern that, in the absence of the quota

increase under the Ninth General Review, the liquidity ratio is projected to fall to a historically low level of about 50 percent by end-1992, compared with the long-run norm of 70 percent, particularly in view of the need to maintain the liquidity of members' claims on the Fund at all times. In this respect, it would have been useful for today's discussion if the staff had provided us with alternative projections that take into account the positive effects of the quota increase.

I am pleased to note the encouraging trend of a positive net transfer of Fund resources to developing countries in recent years, which will contribute to the reinforcement of the central role of the Fund in the international financial system. I welcome the progressive substitution of ordinary resources for borrowed resources, which strengthens the principle that the Fund should rely on its own resources. It will also provide more flexibility which, among other advantages, will also strengthen the confidence of potential creditors. With respect to our strategy for containing and clearing arrears, I would like to emphasize that prompter support is needed to reduce the future impact on the Fund's liquidity position caused by overdue financial obligations.

As to the inclusion of currencies in the operational budget. I would like to reiterate our view that consideration should be given not only to the international reserves position, but also to the external current account position of member countries. Notwithstanding their strong reserves position, some countries may wish to drop out of the operational budget, in view of their weakened current account position, as indicated in the staff paper. In this connection, I am pleased to note that the staff has promised to review the appropriate size of the adjustment coefficient for the total usable currencies in the next liquidity review, as it would become highly controversial once the quota increase comes into effect.

Although the coming into effect of the quota increase should keep the Fund's liquidity in a relatively comfortable position, at least in the medium term, we can expect the potential need for Fund resources to become quite substantial, in view of the prospective demands as well as the possible requests for Fund resources from new members of Eastern Europe and the former Soviet Union.

Mr. Al-Jasser made the following statement:

The staff paper illustrates the downward trend in the Fund's liquidity ratio. However, I share the staff's view that the expected sharp decline in the liquidity ratio does not call for any immediate change in the Fund's policies, given the imminent increase in quotas under the Ninth General Review. Needless to say, it is hoped that the quota increase will come into effect shortly.

Nevertheless, the staff paper does provide some reassuring indications. Indeed, despite a dramatic expansion in the provision of Fund resources to Eastern Europe and the former Soviet Union, the liquidity ratio remains high at 83 percent, virtually the same level as at the end of April 1991. Moreover, the liquidity ratio is projected to decline to only 50 percent by end-1992, which is far higher than the May projection of 38 percent. As the staff paper indicates, this upward revision is primarily due to a downward adjustment in the projected demand for Fund credit. Here, I note that staff estimates of the demand for Fund credit have traditionally been biased upward. That bias is not necessarily in an imprudent direction.

As to the supply of the Fund's usable resources, the imminent inclusion of the Swiss franc into the stock of usable currencies should help bolster the liquidity ratio. Moreover, I note from the staff paper that there has been a marked weakening in the balance of payments position of a number of members whose currencies are included in the operational budget, including those of some large industrial countries, thereby increasing the uncertainty about their usability. As I have stated on previous occasions, this weakening highlights the importance of avoiding the use of quotas as a criterion for the determination of the operational budget, because such an approach would increase this uncertainty and could have severe implications on the Fund's liquidity position.

The staff continues to adopt an ad hoc adjustment factor to the Fund's uncommitted usable resources. I have continually called for a reassessment of this ad hoc adjustment factor, and I look forward to its review in the next liquidity paper. In this context, the maintenance of working balances equivalent to 10 percent of quota should be re-evaluated in light of the coming into effect of the quota increase. It should be noted that the ad hoc adjustment in the stock of usable currencies exaggerates the fall in the liquidity ratio when liquidity is on a declining trend.

In conclusion, the Fund's liquidity remains sufficient for the immediate future, and there is no need, at this stage, for any new initiatives. Naturally, the staff is expected to keep the Board abreast of any new developments.

Mr. Wright made the following statement:

The current review provides some reassurance on the liquidity position in the medium term. The liquidity ratio has remained over 80 percent, which compares well with the long-run average and which is little changed from a year ago. Although the ratio is expected to fall to 50 percent by the end of this year, this position is considerably better than the 38 percent projected by the staff a few months ago. Moreover, this figure of 50 percent takes no account of the addition to Fund liquidity when Switzerland pays its subscription; this payment will increase the liquidity ratio by about 3 percent. The Fund's liquidity position, in sum, should give little cause for concern in the longer term--but only provided that the increases under the Ninth General Review of Quotas come into effect reasonably soon.

There has been a particularly noticeable decline in the level of commitments that the staff expects this year. This decline partly reflects the uncertainty about the timing of arrangements with several large members. It also reflects the slower than expected use of SAF and ESAF resources. This chair has expressed skepticism on several occasions about the staff's projections of SAF/ESAF use, and I am bound to say that even the latest projections still look high. I would be delighted, but surprised, if so many members would be ready to embark on SAF and ESAF programs before the end of this year.

I was disappointed that the staff chose once again not to provide a projection of the Fund's liquidity beyond the end of this year--particularly because much of the reduction in commitments expected in 1992 reflects a deferral to next year. We would normally have expected to see such a longer-term projection six months ago. It would be hard to think of another financial institution that did not produce liquidity forecasts for six months ahead. I well understand the uncertainties surrounding any projections made at the present time. But it would surely have been a relatively simple task to provide alternative projections for 1993 on different assumptions about such issues as the timing of the coming into effect of the Ninth General Review of Quotas and related matters such as the currencies used for payment and drawings of new reserve tranche positions. This absence of forward projections is regrettable, and it makes it virtually impossible for this Board to judge the consequences of a further delay in the effectiveness of the Ninth General Review of Quotas fully.

The staff paper states that more than 65 members are likely to have arrangements in place at the end of this year--an extraordinarily high figure. I wonder whether this is the staff's central estimate, or does it include those members whose probability of an arrangement is low. Second, the staff paper also states that the projected commitments this year include potential demand for compensatory financing for countries affected by the drought in southern Africa. I find it hard to think of many countries in the region that would wish to use the CCFF. So far, the effects of the drought in program countries have been met--correctly, in my view--by augmenting ESAF access or reducing reserve targets.

Like Mr. Al-Jasser, I welcome the staff's undertaking to review the appropriateness of the adjustment factor. I hope that this review will take the form of a fundamental look at the concept of the adjustment factor and its determinants, rather than Directors merely being presented with the result of a black box calculation or adjustment. The Deputy Managing Director originally promised such a review two years ago. I hope that we will not have to wait another two years to see the outcome of this review.

Once the increase under the Ninth General Review of Quotas has become effective, it might be an appropriate time to review the staff's extremely cautious method of forecasting the Fund's liquidity. Past projections, as others have noted, have been consistently too pessimistic. While this chair would be the first to share the staff's desire to exercise prudence in this area, it is the task of the Board to make judgments about the appropriate level of the Fund's liquidity. A systematic bias in the staff's liquidity projections is an inadequate substitute for the articulation of a rigorous and transparent framework to provide the Board with an adequate basis for making judgments.

Mr. Solheim stated that, like Mr. Wright, he was concerned that the current staff estimate of the Fund's liquidity position covered forecasts for the immediate future only. It was hoped that those projections would be revised upward shortly, owing to the coming into effect of the Ninth General Review of Quotas, and would cover a longer period. He welcomed Mr. Dawson's report that in the U.S. Congress no major obstacles to consent to the increase remained, and he hoped that Mr. Filosa could also give assurances about the likelihood of Italian consent. The coming into effect of the increase under the Ninth General Review of Quotas appeared imminent.

However, should the quota increase not be concluded rapidly, he concurred entirely with the staff's suggestion that the situation would call for urgent consideration of alternative financing to prevent the expected steep downward trend in the Fund's liquidity ratio from leading to an untenable position, Mr. Solheim remarked. However, on the basis of the most recent projections, the Fund's liquidity ratio of 83 percent at end-July 1992 was virtually the same as it had been at end-April 1991; the ratio was estimated to fall to 50 percent by end-1992--less than the previous estimate of 38 percent. The reasons for the improvement were many and gave no room for complacency.

Even if the quota increase was concluded without further delay, a heavy demand for Fund resources was expected in the medium term, Mr. Solheim observed. In that event, the liquidity position could easily come under severe pressure; therefore, Directors should monitor the situation carefully. If the liquidity position showed signs of deterioration, the Board should hold a thorough discussion of the Fund's financial situation. He attached great importance to securing the Fund's ability to function when many member countries were faced with unprecedented economic changes.

Mr. Végh said that he agreed that the relative improvement in the Fund's liquidity position since the previous review in April 1992, as measured by the stock of adjusted and uncommitted usable resources, did not imply reduced demand for Fund financial support in the near future. Moreover, such elements as the projected decline in the Fund's liquidity ratio to 50 percent at end-1992 being greater than that which preceded the effectiveness of earlier replenishments, the exhaustion of borrowing agreements under the enlarged access policy and the continued substitution of borrowed resources made the completion of the increase in quotas under the Ninth General Review more pressing. In those circumstances, the cautious methodology for estimating the Fund's liquidity position--including the correction factor of 20 percent to account for possible future weaknesses in the external position of countries with strong currencies--was an appropriate safeguard and should be maintained.

He welcomed the information paper on the rate of charge for the quarter ended July 31, 1992, Mr. Végh remarked. He noted with some concern that the adjusted rate of 7.29 percent in SDRs left no margin to accommodate asymmetrically the expensing of future increases in administrative or capital budget items. He wondered whether the staff could clarify whether the shortfall in the funding of the SCA-2, owing to the floor on the rate of remuneration of SDR 121.9 million on a cumulative basis as of end July 1992, was subject to a ceiling and what time frame was envisaged for its full normalization.

Mr. Orleans-Lindsay noted that, on the basis of current quotas and existing policies on access to the Fund's resources, the Fund's liquidity position appeared broadly satisfactory through the end of 1992. However, the staff assessment indicated that the apparently satisfactory liquidity position, which was largely a reflection of the postponement of certain projected commitments to the early part of 1993, might come under severe strain in the near future. Indeed, given the projected sharp decline in the Fund's liquidity ratio to 50 percent by the end of 1992, the potential strong demand for use of Fund resources in 1993, and the uncertainties surrounding the balance of payments situation of some member countries whose currencies were included in the operational budget, the Fund's liquidity position needed to be monitored closely. In view of the increasing number of new member countries, the staff proposal to review the adjustment factor for the list of currencies included in the operational budget for the next liquidity review was welcome.

The uncertainties surrounding the liquidity projections were considerable and needed to be clarified before alternative courses of action were considered, Mr. Orleans-Lindsay commented. As the staff had indicated, the surest way to replenish the Fund's resources was for the increase under the Ninth General Review of Quotas to come into effect. However, the linking of the quota increase with the proposed Third Amendment was delaying matters. The 70 percent threshold had already been reached for the quota increase, but not for the Third Amendment. He asked the staff to comment on how the Fund could end the deadlock. The Managing Director's statement of December 4, 1991 (BUFF/91/216) on the subject of the increase under the Ninth General Review of Quotas and the proposed Third Amendment had included various options that could be examined to resolve the impasse. Under current circumstances, he strongly recommended further consideration of lifting the link to the Third Amendment on a specified date, in which case new quotas would become effective with the 70 percent requirement on or after that date, even without the entry into force of the Third Amendment.

Mr. Bonzom stated that he agreed with the staff's assessment of the Fund's liquidity and financing needs. The staff paper pointed to a 40 percent increase in the demand for Fund credit in 1992, which was less than the preceding forecast. Nonetheless, it was a substantial increase, which was fully justified in light of the challenges the Fund had been asked to meet in developing countries and former centrally planned economies. Although he understood the staff's arguments for not including any projections for 1993, he would have appreciated the inclusion of a tentative scenario, presented with all due caution, on the evolution of the liquidity ratio for 1993. The increased demand for Fund credit helped explain the projected liquidity ratio of 50 percent for end-1992 and pointed to the urgent necessity, especially in the context of the current international economy, to provide the Fund with the means that it needed to fulfill its mandate and, therefore, to ensure the quick entry into effect of the quota increase.

Mr. Esdar remarked that he agreed with the staff analysis of the Fund's liquidity situation. The short-term prospects appeared slightly better than previously forecast. However, the liquidity ratio was projected to fall to 50 percent at end-1992, and most certainly would be below the long-term norm of 70 percent. The lower liquidity ratio, along with the sharp downward trend in the Fund's liquidity position, underlined the urgent need for implementation of the increase under the Ninth General Review of Quotas. He hoped that the positive indications of the imminence of the consent to the quota increase would materialize.

The increase in the number of Fund arrangements for 1992 was impressive, Mr. Esdar commented. It was also welcome, because it largely reflected the developments in Eastern Europe. Strong efforts by member countries to overcome balance of payments problems based on the support of the Fund were always welcome. On the other hand, the Fund had to be careful that it did not become a permanent source of financing for any member. A balanced picture should consist of new members in need of assistance and countries no longer requiring the financial support of the Fund, because they had succeeded in the establishment of a viable external position. The world economic outlook had noted that 35 developing countries--a great number of them former debtor countries--were now classified as successful adjusting countries. Such experiences should be reflected in Fund statistics in the future.

Mr. Evans commented that the Fund's liquidity position remained satisfactory only because of continuing difficulties in arranging programs and, hence, drawings, but eventually a satisfactory liquidity position would depend on completion of the Ninth General Review of Quotas. Like the staff's estimates of the Fund's liquidity, Mr. Dawson's assessment of the likely timing of the coming into effect of the Ninth General Review of Quotas did not differ much from the assessment he had given one year earlier. Moreover, the coming into effect of the quota increase, because it depended on the acceptance of the Third Amendment, no longer depended solely on the United States.

In those circumstances, it would be imprudent not to plan for contingencies, Mr. Evans noted. The Fund should not be put in a position in which it was unable to meet its obligations to members purely because of short-term liquidity considerations; therefore, Directors should plan now to ensure that the Fund did not reach that position. Hence, he would welcome a staff paper that the Board might consider shortly after the Annual Meetings to look at the options for assisting the Fund's liquidity position, either through traditional borrowing or other borrowing options.

Mr. Prader made the following statement:

> The Fund liquidity ratio of 50 percent currently projected for the end of 1992 is higher than the 38 percent projected in May 1992, but there is little comfort in the change: this upward correction reflects not an increase in the supply of resources available to the Fund, but only a temporary decrease in the demand for use of Fund resources. In other words, the potential mismatch between the demand for and the supply of Fund resources has not been averted, but only postponed.
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> The worsening of the Fund's liquidity position in recent years has two general causes: first, the number of Fund members has significantly increased; and second, Fund members, especially the newcomers, are showing more willingness to accept adjustment programs suitable for the financial support by the Fund. It is debatable how much of the increase in the Fund's financial involvement in recent years is due to an actual increase in the number of balance of payments disequilibria in the world economy, how much to greater adjustment efforts by member

countries, and how much to the extension of the Fund's activities into the new domain of structural reform; but in no case can it be desirable to adjust the Fund's involvement, either qualitatively or quantitatively, to accommodate the liquidity situation of the moment. When for any reason the demand for Fund resources changes, the only correct response is to adjust the adequacy of the supply. We certainly all agree that a market solution to the problem of excess demand, by increasing the price, is not feasible, because it would ultimately amount to penalizing countries for their greater willingness to adjust.

The first prerequisite for stabilizing the Fund's liquidity position thus turns out to be the entry into effectiveness of the increase in quotas under the Ninth General Review. But once this increase has become effective, I wonder what the Fund's projected liquidity will be if Fund arrangements are approved for most new members, if a large number of countries with current stand-by arrangements decide to continue with extended Fund facility arrangements, or if countries to which resources are committed, but not yet disbursed, manage to improve their policies sufficiently to obtain the pending disbursements? All these possibilities are by no means theoretical, and their practical implications will become more relevant as the Tenth General Review of Quotas approaches.

While a review of the Fund's liquidity situation like today's cannot be considered a proper forum for a general discussion of the Fund's future activities, such reviews can quite properly include a comprehensive description extending the present situation over the next 6 to 18 months and pointing out the financial limits of the Fund's activity. It is regrettable that the staff paper omits any quantitative preview of the calendar year 1993 and, therefore, lacks an important element of transparency. One could question the wisdom of abandoning the practice of previewing the next calendar year at a moment of great changes when that practice would have been useful in orienting Directors' thinking.

Estimates of the demand for Fund credit are made independently of the level of available resources. As to access limits, one can make a number of assumptions without prejudging the issues. In this spirit, the quantitative estimates of the demand for Fund resources could be compared with the Fund resources available before and after effectiveness of the Ninth General Review of Quotas. For instance, on the basis of Fund resources before the ninth review, one could calculate the quantity of resources that will be available if a liquidity ratio of 50 percent, for example, has to be maintained.

I support Mr. Evans's proposal for a staff paper outlining different options for the Fund in the event of difficulties with the entry into force of the Ninth General Review of Quotas.

Mr. Posthumus noted that, although some Directors had expressed confidence in the liquidity level of the Fund, he agreed with other Directors who were not satisfied with that short-term view. Not only had the membership expanded, but also the number of programs with both old and new members had increased. The Fund should follow its advice to members: it should look at issues on a longer-term, more structural basis, taking into consideration, for example, the Ninth General Review of Quotas. Future liquidity problems should be acted on now, instead of draining liquidity to the point that future expenditures or access had to be adjusted. The payment of Switzerland's quota was not the solution to the Fund's liquidity concerns.

The access limits of the enlarged access policy should, therefore, be reconsidered--at the latest, when the increase under the Ninth General Review of Quotas took effect, Mr. Posthumus continued. In establishing a new cumulative access level, the Board should take into account the fact that the self-financing ratio, which represented the average access that could be financed and was determined solely from potential quota resources, had lately increased considerably as a result of the entry of new debtors. In addition, the Board should consider starting work on the Tenth General Review of Quotas soon after consent was obtained to the increase under the Ninth General Review.

The Chairman said that he agreed with Mr. Posthumus that the quota paid by Switzerland would not suffice to finance the programs of other new members.

Mr. Nakagawa said that he agreed with Mr. Clark on the urgency of the coming into effect of the increase under the Ninth General Review of Quotas. Although the projected liquidity ratio for end-1992 had been revised upward to 50 percent from the previous projection, its longer-term declining trend underlined the importance of the consent to the quota increase. In that connection, he welcomed Mr. Dawson's view that the increase under the Ninth General Review of Quotas would become effective in the near future. Like Mr. Solheim and Mr. Evans, he wanted to stress the importance of early consideration of alternative financing approaches.

He also agreed with Mr. Wright's advice to the staff to make the process of projecting the liquidity ratio more transparent, Mr. Nakagawa remarked. He wondered how the staff had incorporated in the current projections the prospect of possible new second phase commitments to the Russian Federation.

Mr. Fernando stated that on the general question of liquidity--with due recognition of the staff's conservative approach to the projections--

there was no imminent threat of a sharp downward fall in the liquidity ratio. The projected ratio was typical of the period immediately before the coming into effect of a quota increase. In that connection, he hoped that the increase under the Ninth General Review of Quotas would come into effect soon. Certainly, there was a strong underlying demand for Fund resources, and he looked forward to a longer-term projection of demand and supply at the next liquidity review.

As to the adjustment factor in the stock of usable currencies, he agreed with other Directors that the matter should be addressed at an early date, Mr. Fernando said. He wondered whether the decision on the substitution of ordinary for borrowed resources, which was valid for arrangements made prior to September 30, 1992--or the date of the effectiveness of the increase under the Ninth General Review of Quotas, if earlier, which was doubtful--would be reviewed before end-September 1992. That decision was closely linked to access limits.

Mr. Mwananshiku said that the financing needs of the developing countries, especially the heavily indebted ones in sub-Saharan Africa, had not abated. Moreover, exogenous shocks, such as the current drought in southern Africa, had continued to play havoc in those fragile economies and had aggravated external imbalances in many of them. At the same time, attempts to meet the needs of countries in central and Eastern Europe and the former Soviet republics undergoing economic transformation to market systems had begun to exert pressure on Fund resources. The resulting high demand for Fund arrangements had weakened the Fund's liquidity position, as further demonstrated by current projections.

The projections of the Fund's liquidity were still characterized by a high level of uncertainty, reflecting their sensitivity to the evolution of economic and financial situations in different member countries, Mr. Mwananshiku commented. The wide variation between the estimated liquidity ratios in the most recent three reviews--including the current one--demonstrated the difficulty of making such projections and served as a reminder of the problem of predicting the real world situation.

The staff had concluded that the current set of estimates showed some improvement over the May 1992 position, Mr. Mwananshiku remarked. That improvement was mainly attributable to the downward adjustment in the demand for Fund resources by about 12 percent. Nevertheless, the demand for Fund support remained high, and many arrangements were expected to be concluded before the end of 1992.

The change in the liquidity ratio between the end of 1991 and the estimate for end-1992 showed a precipitous decline driven mainly by the high demand for Fund resources to support structural adjustment and economic transformation in many member nations, Mr. Mwananshiku observed. As emphasized by the staff and many earlier speakers, that decline underscored the need for a speedy conclusion of the Ninth General Review of Quotas. Despite the difficulties experienced by many member countries in accepting the Third

Amendment, almost all the members of his constituency had now completed the necessary procedures for the consent to the quota increase and the acceptance of the Third Amendment. The favorable action by his respective authorities reflected the importance that they attached to strengthening the Fund's position to provide support to members' adjustment programs.

Mr. Jaramillo remarked that the staff projection of an expected decrease in the Fund's liquidity ratio to 50 percent by end-December 1992 was an improvement over the May 1992 estimate of 38 percent. Nevertheless, the 50 percent level would be low enough to cause some concern, were it not for the increase in quotas expected in the near future. It was thus important to ensure that the increase in quotas would come into effect soon.

If the United States were to accept the quota increase and the Third Amendment within the near future as Mr. Dawson expected, votes representing only a little over 1 percent of quotas would still be needed in favor of the Third Amendment in order for the quota increase to come into effect before the end of the year, Mr. Jaramillo said. In that event, the liquidity ratio would again rise far above the 100 percent level. He would stand ready to encourage his authorities to accelerate, to the extent possible, the decision processes for acceptance of the Third Amendment.

Mr. Deng remarked that he agreed with the staff analysis and assessment of the Fund's liquidity position, including the continued high demand for the Fund's resources through 1992. It was, however, reasonable to believe that the demand for Fund's resources would be even higher subsequently, given that the expanding Fund membership would likely lead to larger financing requirements. In that connection, the downward trend in the Fund's liquidity ratio as projected in the staff paper was of concern. He therefore agreed with other speakers and the staff on the urgency of replenishing the Fund's resources through the increase in quotas under the Ninth General Review of Quotas. He looked forward to the staff's updated projections of the Fund's liquidity position once the increase in quotas had come into effect.

Mr. Filosa said that during the Board recess he had discussed the quota increase and Third Amendment with his authorities in Rome. The approval of the quota increase--not the Third Amendment--was included in a package of measures that needed to be ratified by Parliament. He did not expect major problems with its passage. He was less optimistic, however, on the question of the Third Amendment, which required parliamentary approval and a more complex procedure that involved the Ministry of Foreign Affairs.

He doubted that it would be possible to obtain Italy's approval of the Third Amendment by the end of September 1992, Mr. Filosa indicated. He had stressed to his Italian authorities the importance of not being an impediment to the approval of the quota for the entire membership because of the likely delay in securing approval of the Third Amendment. In any event, as he had stressed during previous Board meetings, the delay was for merely procedural reasons. He hoped that in the near future Italy would approve the Third Amendment, but that approval would likely come after the end of September.

The Treasurer said that the staff had not made projections of the Fund's liquidity into 1993, because assumptions used in the current liquidity review and the previous two reviews had been based on current quotas and current access limits, which were not expected to last into 1993. Also, it would be somewhat pre-emptive of the decision that the Board had taken to review the Fund's financial position, including liquidity, access limits, and alternative actions that could be taken if the quota increases had not come into effect by September 11, 1992. The staff could have said that if the current access limits and quotas remained in effect into 1993, there would be zero liquidity, but requiring the Board to review such a position considerably in advance would not be helpful. However, unless the Board considered that the current review of the liquidity position constituted a review of the status of the coming into effect of the quota increase and acceptance of the Third Amendment, it would need to review the situation again by September 11, 1992 to decide what steps should be presented to the Interim Committee for consideration.

The question had been raised as to whether the emphasis in the operational budget--now before the Board on a lapse of time basis--should be on a member's reserves or the current account/balance of payments position in deciding whether it should be included in the operational budget, the Treasurer recalled. The Fund was obliged under its Articles to analyze the reserves and the balance of payments position as one element. In the event that a member country had fairly high reserves, even though there might be a moderate balance of payments deficit in the current account, the normal guidelines of the Board would require that the country be considered for inclusion in the operational budget.

The liquidity ratio had been revised upward not only because demand had been postponed, but also because one country's large program had gone irretrievably off track, the Treasurer explained. That member country had been withdrawn from the operational budget, and its program would be replaced with a smaller stand-by arrangement. Had that country been included in the liquidity ratio, the ratio would have been 3 percent lower. There was one other country that could not yet be taken out of the operational budget, but likely would be later in 1992.

Switzerland had not been included in the calculation of the liquidity ratio because it had not yet made its reserve asset payments; more important, it was not yet part of the operational budget, the Treasurer noted. The liquidity ratio was calculated using the list of countries and currencies usable in a liquidity review that were in the operational budget. Switzerland was probably strong enough to go into the operational budget--the Board would first have to approve a decision to include it--and, as Mr. Wright had said, its participation would probably increase the liquidity ratio by about 2.7 percent.

The figure of 65 countries with programs under the General Resources Account or under the ESAF and SAF was a straight calculation of the number of countries expected to have programs under way or be entering into programs by the end of 1992, the Treasurer stated. Commitments of SDR 11.5 billion were expected under the General Resources Account and SDR 1.9 billion under the SAF and ESAF.

The request that Mr. Wright and Mr. Nakagawa had made on a number of occasions for greater transparency in the estimates essentially entailed the inclusion of the country-by-country accounting used to put the liquidity review together, the Treasurer commented. At the review of the methodology used to assess the Fund's liquidity 18 months ago (EBM/91/45, 3/29/91), the Board had concluded that it would not be particularly useful to have an individual country-by-country presentation in the liquidity review. No southern African countries had been included on the CCFF list for purposes of the current review, given that they were expected to come under ESAF programs. If the Board was presented with a detailed country-by-country estimate of which members the staff expected to enter into programs in the current year, what the probability of their entrance was, and what amounts their programs would entail, the Board would have some considerable difficulties in handling a liquidity review--a view that had been expressed when the topic had been discussed previously.

The shortfall in the SCA-2 was due to the fact that the floor--in terms of how low the rate of remuneration could be reduced because of the obligation to maintain the rate of remuneration and the SDR rate within a 20 percent band--had recently been reached, the Treasurer explained. The shortfall in the SCA-2 by creditor countries would have to be made up over time. In that connection, the Fund was currently in a fairly tight squeeze, as the SDR interest rate was falling quite sharply--it was now down to 6.14 percent, compared with over 9 percent two and a half years ago. In that sense, the scope for taking from the creditor positions remuneration to maintain the 3-1 contribution in the SCA-2 account was inherently limited and had also been deferred. It had not been eliminated.

The Executive Board, the Treasurer noted, was required to review the status of consents to the increase in quotas under the Ninth General Review of Quotas and acceptances of the Third Amendment and decide what steps should be taken before September 11. The Board could consider the current discussion a substitute for that review and come to the conclusion that the current liquidity basis was manageable until the end of September when the Board would, in any event, need to look at the decisions on the extension of the period for consent and on the substitution of ordinary for borrow resources, before September 30, 1992. The latter approach would answer Mr. Evans's question about the need to examine alternative financing options after the Annual Meetings, and would be necessary if the quota increase was delayed for some time longer than had been intimated during the current discussion.

As to whether Russia was included in the liquidity ratio estimates, he would prefer to maintain the normal neutrality by not specifying what countries were part of the calculations, the Treasurer said. There were a number of large countries whose quotas were included in the estimates for the balance of 1992.

Mr. Wright remarked that he had not intended that there be any suggestion underlying his statement that he wanted to see projections for individual countries. Such an approach would be both inappropriate and unworkable. On the specific issue that he had raised about the CCFF, he had been concerned that a certain category of countries had been affected by a particular phenomenon, namely, the drought, which might have had a bearing on the liquidity projection. The staff report had mentioned the potential demand for compensatory financing for export shortfalls, and the inclusion of countries adversely affected by the drought in the total demand for compensatory financing. That statement was not consistent with the Treasurer's assertion that no southern African countries had been included on the CCFF list used to calculate the liquidity ratio, because those countries were expected to come under ESAF programs.

There could be a great deal more transparency and rigor in the calculation of the liquidity ratio without going so far as providing individual country estimates and individual probabilities, Mr. Wright commented. A more transparent framework would enable the Board to make an independent judgment on the validity of the projection and on the important related issue of the appropriate level of reserves. The liquidity ratio as it was currently forecast had a systematic bias, which made it difficult for the Board to assess its appropriateness.

Mr. Evans said that he wondered whether the Treasurer could clarify his response to his suggestion of a staff paper to examine the options for dealing with the liquidity situation. The Treasurer had referred to the need to take decisions on the Fund's liquidity and reserves position by the end of September. He wondered whether a staff paper could be prepared in that short a time. Because the Board was not scheduled to meet between September 15, 1992 and October 4, 1992, discussing those matters after the Annual Meetings but before the end of September was problematical. Assessing the options for dealing with the liquidity situation in the event of a short-term delay in the coming into effect of the quota increase would require careful consideration, not least because of the increase in the membership.

The Treasurer responded that Directors first needed to determine whether the Fund's liquidity position was sufficient for September 1992, without having to meet for further consideration before September 11, 1992. When the decision to extend the period for consent to increase quotas and the substitution of ordinary for borrowed resources was taken--whether at the end of September or soon afterward--a number of factors would need to be considered in examining alternative financing options, namely, the demand for Fund resources, current access limits, the liquidity position, and the expected length of the delay in the coming into effect of the quota increase.

Any systematic upward bias in the presentation of liquidity ratio estimates was probably due to the calculation of the probabilities for a particular arrangement--a calculation that a number of departments, particularly the area departments and the Treasurer's Department, were anxious to do as accurately as possible, the Treasurer commented. Often the probabilities tended to be high. There was no bias in the programs expected to come into effect during a particular period.

Mr. Wright responded that he appreciated the Treasurer's comments; it was a comfort to Directors as prudent people to know that there was a systematic bias. However, the staff could be more precise by providing a more transparent framework that would not require Directors to depend on the output of a black box with a margin added for safety.

Mr. Al-Jasser indicated that he agreed with Mr. Wright, especially on the consistently upward bias in the estimation of the liquidity ratio. A more transparent way of presenting that information would be more appropriate. Once the new quotas came into effect, such a framework would probably be easier to construct, because at least the pressures of a low liquidity ratio would be eliminated at the outset. More consistent liquidity estimates would benefit the work of both the Board and the staff. Perhaps the Board should follow the example of the world economic outlook and analyze the variances between the projected and actual liquidity ratios to see how consistent the bias was in one direction or another.

The Chairman responded that the improvement in the Fund's liquidity position after the quota increase was not likely to last long. A degree of conservatism in calculating the liquidity ratio was quite in order, because the risk of a liquidity shortfall was more serious than the risk of appearing to be overly conservative from time to time.

Mr. Al-Jasser commented that the staff could have provided two scenarios in estimating a 1993 liquidity ratio, one with the quota increase and one without, so that Directors could better consider the year ahead. If the quota increase did not come into effect, the Treasurer had said that the liquidity ratio might well be zero. Dramatic statistics might well be worth looking at. Once the quota increase came into effect, the decline in the liquidity ratio would be more gradual than it would currently appear.

The Chairman noted that the Board of Governors would take exception to the Fund's consideration of a hypothesis of zero liquidity, given the Fund's position in the world monetary order.

Mr. Al-Jasser remarked that the issue at hand was not so much a prudent upward bias in the liquidity ratio calculation, but a dramatization of the Fund's liquidity. In 1990, when the Board had been discussing the quota increase, the liquidity ratio estimated for end-1991 had been 38 percent.

There had been a consistent overestimation of demand. He had said in his statement at the time that prudence was important, but it should not be overdone. Just as underestimating liquidity was risky, consistent overestimation of the demand to give a pessimistic view might build up the impression that demand would always be overestimated and the Fund's liquidity ratio would always appear too low, even though it was not. Biases in either direction ought not to be condoned.

Mr. Nakagawa said that unless the Board reviewed the details of the demand projections, it could not properly assess how realistic the staff's projections were. Otherwise the Board could only take the staff's figures on faith and say that any liquidity ratio below 70 percent--the historical average--was a cause for concern and any figure above 70 percent was comfortable. But that was not the purpose of the exercise.

He agreed that the staff should not disclose country-by-country specifics, Mr. Nakagawa continued. However, on previous occasions, the staff paper had included projections of demand with the resources available by geographical area, and he would appreciate more detailed information on that order.

Mr. Dawson stated that, given more area departments, the Board could pick apart any geographic numbers that were presented, an action which might contradict the effort to validate the liquidity ratio estimate. His chair had long made the point that Mr. Wright and Mr. Al-Jasser, in particular, had made about the accuracy of projections, which had led to skepticism about out-year projections in any event. Therefore, nothing had been lost for purposes of the current debate by not having the 1993 numbers.

He agreed with the Chairman that, at that point in time, there was a certain element of futility about that debate, Mr. Dawson continued. The Board needed to address the issues that a number of chairs had traditionally raised. The Board was close to having that opportunity--he hoped it would not be in the context that Mr. Evans had suggested--with the presumption and hope that when the quota increase came into effect, the Board would have a natural opportunity to look at all those issues. Unfortunately, inherent in those forecasts was an element of false precision.

Frankly, his chair had never taken out-year liquidity numbers particularly seriously, Mr. Dawson commented. He had understood from his predecessor that strong skepticism about the numbers had been an element in the delay in the Board's conclusion of the Ninth General Review of Quotas. In part, that skepticism had been justified over time. Directors' positions on liquidity were well known. With the Annual Meetings approaching, it would be better to postpone discussion of the liquidity ratio and associated issues until the new quotas came into effect.

As to financing alternatives in case the quota increase did not come into effect, the General Arrangements to Borrow were a temporary arrangement that existed, in part, for that reason, Mr. Dawson said. He hoped that the coming into effect of the quota increase would be resolved by September 30, 1992. With respect to the September 11 deadline, there was a requirement in terms of the substitution arrangement of ordinary for borrowed resources. The Board's interest in the matter was an updated assessment, not necessarily so that the Board would take any action, but so that the Board and the Managing Director would discuss the issue and be able to inform the Chairman and other members of the Interim Committee of the situation as it existed as close as possible prior to the Interim Committee meeting. The quota legislation, if consented to, had always been expected to come into effect after September 11, 1992. He hoped that the U.S. Congress would give its consent by the time of the Annual Meetings or September 30, 1992.

Mr. Posthumus commented that making a realistic estimate was, by definition, impossible. In the past few years, the number and size of programs had increased significantly and resulted in estimates that were too optimistic. If the methodology used in estimating liquidity was changed, there would be a danger that in two or three years, when the demand for programs was closer to normal, demand would be underestimated substantially. The Fund would not be the first institution to have done that. The Board, therefore, should be extremely cautious in changing the system for estimating the liquidity ratio.

The Chairman made the following concluding remarks:

The present review has been useful as an interim review, pending the coming into effect of the increase in quotas under the Ninth General Review. The projected decline in the end-1992 liquidity ratio has to be considered in that context, and the staff's projections of demand for Fund resources reach only to the end of the year for that very reason. I would, however, stress that the projected strong demand for the Fund's resources over the balance of 1992, on the basis of present quotas, is unsustainable, except in the expectation that the increase in quotas will come into effect soon.

I appreciate the fact that considerable and welcome progress has been made with respect to consents to the quota increase and acceptances of the Third Amendment. At present, acceptances stand at 62.80 of total voting power, and we have heard Mr. Dawson's expectation of prompt action on the U.S. side following Congress's return from vacation after Labor Day. I echo all speakers this morning in urging each member that has not yet consented to its quota increase or accepted the Third Amendment to do so as soon as possible--hopefully, before the Annual Meetings.

We recall that decisions on the extension of the period for consent and on the substitution of ordinary for borrowed resources are effective only to the end of September. The decision calls for a review of the status of consents and acceptances not later than September 11, 1992, in order to have the most accurate possible data to give to Fund Governors and to examine the steps that could be submitted for consideration by the Interim Committee in the event that the procedures on consents and acceptances have not been completed. I very much hope that the quota increase and Third Amendment will be in effect by that time. If not, we will need to come back to the issue before September 11. We recall the comments made by Mr. Evans that, shortly after the Annual Meetings, the Board should consider alternative financing to meet the Fund's liquidity requirements.

Finally, I have heard--and agree with--the calls made by a number of speakers for longer forward-looking analysis of the Fund's liquidity position.

2. UNAUTHORIZED DISCLOSURE OF INFORMATION

The Chairman informed Executive Directors of a recent unauthorized disclosure of information. In the current issue of the Morning Press, sources from the Executive Board were quoted as saying that the delay in the Board's discussion of the European Monetary Union issue was at the request of at least one European Executive Director and was linked to the French vote on the Maastricht Treaty on September 20, 1992. Such a linkage was nonsensical. He asked Executive Directors to remind their offices that discretion about the work of the Board was essential. Likewise, the staff should be discreet, and he himself and the Secretary had worked to that end.

3. ALBANIA - 1992 ARTICLE IV CONSULTATION, AND REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with Albania and its request for a 12-month stand-by arrangement in an amount equivalent to SDR 20 million (EBS/92/121, 8/3/92; and Cor. 1, 8/20/92). They also had before them a background paper on recent economic developments in Albania (SM/92/165, 8/17/92).

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

A staff team that visited Tirana during August 19-22, 1992 received the following additional information on recent developments and policies. All prior actions have been implemented, as described in the staff report, with a few minor differences. Retail prices of kerosene and medicines have been raised by 300 percent and 150 percent, respectively--somewhat less than originally planned--and price increases for schoolbooks have been postponed until September 15, 1992, pending an inventory of libraries and bookstores. Also, the new draft customs law, 1/ although approved by the Council of Ministers, was not enacted by Parliament before the August recess; it is expected to be approved in early September 1992. The impact of these developments on the budget for the second half of 1992 is marginal and could be offset by receipts from a newly levied hotel tax.

Output continues to suffer from the extremely difficult starting conditions, with close to one third of industrial enterprises completely shut down and most others severely disrupted. With budgetary subsidies stopped and access to bank credit much reduced, there appears to have been a marked increase in interenterprise arrears already. These arrears underscore the urgency of proceeding quickly with enterprise restructuring and closures to safeguard the financial parameters of the program. Agriculture is starting to suffer from drought, exacerbated by the breakdown of much of the country's irrigation facilities. Monthly inflation in July 1992--prior to the recent decisive phase of price reform--continued at around 6½ percent, dampened by the seasonal availability of certain food items--mainly fruits and vegetables.

Following the floating of the exchange rate on July 1, 1992, banks and other dealers have started to operate in the unified and free exchange market, with the lek appreciating gradually from the parallel market rate in late June--around lek 130 per U.S. dollar--to below lek 100 per U.S. dollar in the third week of August. This appreciation has occurred notwithstanding small net purchases from the market by the banking system, including the Bank of Albania. 2/

While the initial impact of price reform has been absorbed relatively well, inadequate supplies in urban centers of certain basic commodities with liberalized prices 3/ have resulted in an overshooting of prices in those cases. The authorities are considering temporary price monitoring mechanisms to prevent such monopoly-based overshooting. The petroleum price structure is also under review to remove certain unintended anomalies in the pricing of some by-products, without affecting total budget revenues.

1/ The law would reduce the number of tariff rates to three (5, 15, and 30 percent) while raising the average tariff from about 10 to 15 percent.

2/ Cumulative net purchases of about $1.5 million.

3/ Including milk, meat, eggs, rice, and sugar. The authorities attributed these shortages to delays in food aid deliveries as well as the breakdown of domestic distribution systems.

With respect to interest rate policy, following the introduction in July of a new schedule of maximum lending rates for banks, the Bank of Albania in mid-August replaced those ceilings with indicative "guiding rates" to give further flexibility to banks with different cost and demand conditions.

On external financing, the outlook remains essentially as described in the staff report, with some further progress in meeting Albania's emergency food import needs in 1992/93.

Mr. Filosa made the following statement:

The Executive Board discussion that will conclude the first Article IV consultation with Albania and consider the Albanian Government's request for a stand-by arrangement will officially mark the beginning of a new era in Albania--an era that will relegate to the past Albania's drive to autarky and economic centralization and bring to an end the isolation from the rest of the world forced on the country by four decades of rigidly applied orthodox socialism.

Indeed, autarky and total centralization of economic activity long represented the cornerstones of Albania's way to socialism. Both had been carried out to an extent that was unprecedented in the socialist world and that distinguished Albania as a unique model in the socialist experiment. In the end, such an experiment turned out be extremely costly. It produced a system where the pursuit of economic incentives, the search for comparative advantages, and the respect of financial constraints were deemed irrelevant, if not unlawful, thereby depriving the economy of the signals necessary to achieve a minimum of rationality in the allocation of resources.

As a result, the country is, today, by far the poorest nation in Europe, and, following the breakdown of the old regime, the economy has collapsed under the weight of an enormous foreign debt, severe price distortions, and an archaic productive structure. Moreover, the fiscal position of the country has become critical, and the credit and monetary aggregates have gone out of control. Chronic shortages and social tensions have resulted, and most government functions have been hampered.

But the break with the past is now a matter of fact. Albania is, today, a full-fledged member of the international community, and the newly elected democratic Government is strongly determined to reform the country to enable it to exploit the opportunities for sustainable growth and development associated with open trade and free markets.

The tense social situation that followed the collapse of the previous regime required the restoration of public order and essential government functions before any program of economic reconstruction could be undertaken. In this respect, significant progress has been accomplished. In March 1992, a new Government was democratically elected, and local elections were held thereafter. Since then, the authorities have worked hard to redefine the responsibilities and functions of public administration in the spirit of democratic principles and market-oriented norms.

In the near future, Albania will have to undergo a long process of forceful financial adjustment and deep economic reforms. As the staff admits, "the task...is monumental," and no such effort will be possible without the active involvement of the international community at large, most notably, the Bretton Woods institutions. Hence the authorities attach much importance to their request for the proposed stand-by arrangement.

With social stability broadly regained and a basic institutional setting in place, the authorities have resolved to embark on a three-pronged economic strategy. Underlying that strategy was their decision to adopt a strong shock therapy approach to economic recovery, as they recognized that the existing productive and administrative structures would not have responded to a gradual approach. More important, with this decision the authorities intended to signal--both to the country and the international community--the irreversible nature of the transition process. Albania's irreversible jump to democracy had to be matched by an equally irreversible jump to the market.

The first step of the strategy required the authorities to take a number of important prior actions--in consultation with the staff--that would create the economic conditions required in order for a strong economic adjustment program to be successful. The second step is undertaking, with the support of a stand-by arrangement, an economic program that would not only consolidate the initial adjustment, but would also lay the ground for medium-term, wide-ranging structural reforms. The third step, following the successful conclusion of the stand-by arrangement, should allow for the authorities' continuation of their program of structural reforms under an ESAF arrangement.

The accelerated sequence of prior actions taken by the Government covered three major policy areas: price liberalization; trade and exchange reform; and financial reform, including interest rates corrections. In the price area, effective August 1, 1992, all remaining price controls in Albania have been eliminated, except for a few products that are still administered.

For those administered products, however, prices have been subject to major adjustments. Important measures that attest to the seriousness of the authorities' policy commitment include the fivefold adjustment of the price of bread and the fourfold increase in the price for wheat. The authorities agree to revise these prices periodically, as needed, over the next few years. Such price revisions will have a large beneficial impact on public revenues and will allow the Government to reduce drastically the related budgetary subsidy components. The authorities expect that the price liberalization will stimulate a significant output response, especially in the agricultural sector, where privatization is already at an advanced stage.

In parallel to the price reform, radical steps were taken by the authorities to reform the exchange and trade system aimed at ultimately achieving external current account convertibility of the lek. As a first step, the Government, effective July 1, 1992, adopted a floating exchange rate. Given the central bank's lack of international reserves and the difficulty--under present economic circumstances--of pegging the exchange rate at any given level, such a choice was the only reasonable one. The Government also issued new regulations for the operation of a free foreign exchange market and lifted most restrictions on current account transactions. The remaining restrictions cover a few import items for safety and environmental reasons and the export of certain food and food-related items. These export controls are, in fact, justified, as they purport to avert diversion of foreign aid and subsidized products. Furthermore, the authorities have abolished all state trading monopolies and simplified the recently introduced customs tariff structure.

The third area where relevant prior action was taken is financial policy. In pursuing the objective of creating the foundations for an efficient two-tier financial system, the authorities enacted legislation providing for the establishment of an independent central bank, with adequate regulatory powers, and a legal framework for the development of a local commercial banking sector. Furthermore, as a way to help restore macroeconomic balance, the authorities raised the interest rates sharply on bank deposits and loans and introduced a new reserve requirement system for all banks and deposits, including penalties for lack of compliance. The difficult political and economic circumstances under which the authorities took these measures should leave no doubt as to their determination to do whatever it takes to accomplish the transition process successfully.

As part of the three-pronged strategy, the authorities now intend to undertake the strong, Fund-supported economic program described in the Government's letter of intent. The program encompasses a tight adjustment component and the inception of far-reaching structural reforms. Its essential elements include the reassertion of full government control over fiscal policy, the imposition of strict limits on credit and money growth, and the adoption of a tight incomes policy. The program is also designed to provide the authorities with the necessary technical and financial support for consolidating the structural reforms already initiated and for intensifying the reform of the agricultural sector and the process of privatizing state enterprises.

On the macroeconomic side, the bulk of the adjustment maneuver rests on fiscal policy. For the second half of 1992, the program targets a reduction in the overall fiscal deficit on a cash basis to 19.1 percent of GDP, from the 50.2 percent level recorded over the January-June 1992 period. At the same time, the authorities intend to reduce the monetary financing of the deficit from over 50 percent of GDP to around 16 percent by the end of 1992, and to 10 percent in 1993. Such targets represent major corrective steps from past trends, especially considering the formidable difficulties and uncertainties that presently face fiscal policy.

In light of the erosion of the country's tax base, the achievement of the 1992 fiscal targets entails a substantial restructuring and reduction in government outlays. Compared with the first six months of the year, current expenditure will be cut almost by half during the remaining part of 1992. Savings will be attained from limiting the wage bill; from cutting military, internal security, and administrative spending; from terminating the current system of 80 percent wage payments to idle workers; and from substituting it with temporary, and progressively diminishing, unemployment benefits. Considerable progress, however, will come from subsidy reductions: subsidies to enterprises and for price support in proportion to GDP will decline from 18.7 percent in the first half of 1992 to 2.6 percent in the second half, and to 1.1 percent in 1993--levels considerably lower than in other Eastern European countries. In addition, investment spending will necessarily be curtailed over the remaining part of 1992 to help the rapid reabsorption of the deficit.

On the revenue side, the closure of many state enterprises, the lack of tax discipline in the country, and the weakness of the tax administration caused public revenues to shrink dramatically. Major efforts are now being pursued to restore the tax base, but, notwithstanding the measures already in place, the revenue expected for the second half of 1992 will not be sufficient to cover even the most essential budgetary expenditures. To regain the ground lost, the authorities are implementing a comprehensive reform of the tax structure aimed at establishing a broad-based system capable of taxing the future private sector. They recognize, however, that such reform cannot be effected successfully without first rebuilding the country's fiscal administration. They have thus instituted expenditure control procedures and passed a new budget law to reorganize and strengthen fiscal management operations.

The Government is also considering the fiscal framework for 1993. Owing to the uncertainties and risks surrounding the adjustment that is under way, it is still too early to formulate specific targets for the future. Yet, there can be no doubt that the direction of such actions will have to point toward bringing the tax reform to a successful completion and furthering the reduction in the deficit through the rationalization and monitoring of expenditures, especially in the military and social security sectors. Extreme care is being exerted by the authorities in revising the unusually generous social security and assistance system inherited from the past regime.

My Albanian authorities are fully convinced that the transition to a stable market economy requires reorienting credit and monetary policies to the objective of price stability and, ultimately, delinking monetary policy from budget financing. Accordingly, the program's monetary and credit aggregates are targeted toward bringing inflation rapidly under control. The reform of the financial sector now under way will eventually allow the monetary authorities to rely on market instruments of monetary control; however, until they gain sufficient experience in the use of such instruments and until the domestic financial system becomes capable of correctly and swiftly transmitting to the economy the monetary policy signals, credit ceilings on individual banks will remain the principal instrument of control at the authorities' disposal.

Interest rates will increasingly play an allocative role in the Albanian economy, but, until competition emerges in the financial market, they will continue to be set administratively. The authorities intend to review periodically the interest rates on bank deposits and loans, with the expectation of introducing positive real levels by the end of the program period.

The task of monetary and credit policy is considerably complicated by the legacy of nonperforming loans in the banking system. The authorities are planning to absorb these loans into the budget gradually. Depositors will share part of the burden as inflation erodes the economy's monetary overhang, and sanctions will be imposed on those enterprises whose loans will have to be taken over by the Government.

Key to the priority of breaking the escalating wage-price spiral is incomes policy. During the second half of the current year, nominal targets will be set for average civil service salaries, and limits will be imposed on wage increases in state enterprises and public administration, with a view to reducing real wages and bringing them in line with the large drop in domestic output since 1989. Specific provisions will govern wage adjustments. In particular, an equal lump-sum compensation has been extended to civilian central government employees to protect their salaries exclusively against the direct effect of the recent increases in administered prices. On September 1, 1992, a restructuring of the central government employees' wage scale for civilians will take effect in order to introduce an incentive element in the salary structure and curb the current exodus from public administration. To ensure the effectiveness of the incomes policy, the authorities have passed laws that enforce tax-based sanctions for those violating the limits.

With respect to structural policies, the authorities will pursue under the program the reforms already initiated. In the exchange and trade sector, they are planning to remove the remaining restrictions on current account transactions gradually. Although the average tariff rate has been increased for revenue purposes, it will be adjusted to comparable international levels as soon as the improved budget conditions permit.

As to the privatization and restructuring of state enterprises, the authorities fully share the view that, to be able to remove the long-standing impediments to growth, they need to establish an economic system based on private property and free individual initiative. They are therefore seeking to establish the legal framework and the commercial codes necessary to protect private property rights and to encourage private investment. Considerable progress has already been achieved in privatizing small units in the services sector with the law passed in August 1991; however, the authorities are planning to amend it in two major respects to cover important sectors that are presently excluded and to allow foreign investment and participation in the privatization process. For the enterprises remaining in the public sphere, a law was approved in July 1991 to restore corporate governance and to perform the necessary reorganization. The authorities aim to make these enterprises independent decision units that are free to use resources on the basis of liberalized input and output prices, subject to hard budget constraints, and free to hire and fire workers and organize trade based on individual contracts.

In light of the importance of the agricultural sector in the national economy, absolute priority is given by the authorities to the implementation of agrarian reform. Indeed, the process of land distribution in Albania is proceeding at a considerably faster pace than in other Eastern European countries, as already 80 percent of the land of cooperatives has been distributed to private farmers. The program includes two elements that will play a crucial role in the success of the reform. The first--which was discussed earlier--is the price liberalization component of food and food-related items.

The second is the authorities' plan to amend the Land Law before the planting season, with a view to fostering the emergence of a free market for land. To this end, new land titles will protect land ownership and former owners' claims will be acknowledged, though compensation will be financial, with no provision for physical restitution. All these elements combined should grant domestic farmers strong incentives to increase investment and production. The privatization of the large state farms has not yet started, but the authorities are working, in close collaboration with the European Commission and the World Bank, on a plan to convert some such farms into stock companies, while in other cases joint ventures with foreign investors have been established.

The staff report indicates the exceptionally critical balance of payments and financing constraints facing Albania in the near and medium term. No matter how tight domestic policies and how large the savings attainable, Albania will need significant foreign cooperation for a protracted period of time.

My Albanian authorities are grateful to official donors for their generous humanitarian and concessional assistance, which has helped the country survive a difficult phase. They are reassured by the fact that the international community, despite the large financing requirements, is providing Albania with additional assistance to close the estimated gap for the period ending in December 1992. They are also confident that by the time of the first program review, the European Commission and G-24 donors will be able to support Albania's effort to regain external viability gradually.

However, the authorities also wish to convey to the Executive Board their concern about the recent emergence of basic commodity shortages, owing to delivery delays. Such shortages can be severely detrimental, especially at a time when Albania is embarking on so radical an economic reform process. In the view of the authorities, the sustainability of the program itself is crucially linked to the adequate provision of such commodities.

With respect to Albania's commercial indebtedness, the authorities intend to cooperate fully in identifying a solution.

To this effect, they have recognized the sovereign nature of the debt and wish to start negotiations with the banks soon. For the near term, however, there is no alternative to the deferment of payments to commercial creditors.

Undoubtedly, the Albanian authorities face a difficult situation. The program that they are prepared to undertake--which, however important, represents only a first step in the reconstruction of the country--contains substantial risks. The wide-ranging nature of the policies envisaged, the particularly difficult economic conditions, and especially the country's limited institutional capacity and lack of familiarity with market-type rules and laws all raise the level of such risks.

However, there does not appear to be any real alternative for Albania at this stage. The authorities can only assume such risks with conviction and determination, which they have courageously resolved to do; they so far have tried their best. They have made a tough choice, and they see no chance of withdrawing from it. Moreover, I can assure the Board that the commitment to the transition process has been soundly reaffirmed at all levels of the Albanian Government.

I wish to conclude my remarks by extending to the Fund's management and staff my Albanian authorities' gratefulness for the assistance they have received in this difficult initial phase of the transition, and by expressing their hope that the international community will do its part by joining commensurately in the effort.

Mr. Al-Jasser made the following statement:

Albania faces exceptionally difficult circumstances. As described in Mr. Filosa's statement, the authorities have responded courageously to this situation by setting forth on an ambitious and indispensable program to stabilize, transform, and revitalize the economy. Saddled with a long legacy of autarkic isolation, the authorities have launched a drastic program to arrest the steep downward slide of the economy and prevent the emergence of hyperinflation. At the same time, the structural transformation of the economy has been set in motion. The authorities' firm sense of purpose is demonstrated by the firm actions already taken: the comprehensive liberalization of prices; the removal of virtually all exchange and trade restrictions; the reform of the tax system and the financial sector; and the passage of a revised enterprise reform law. The authorities recognize that, for the time being, their implementation capacity is limited and, therefore, are focusing their efforts on a short list of priorities. Such an approach is sensible and commendable.

I support the proposed stand-by arrangement with Albania. However, the stand-by arrangement is only a first "kick-start" toward the creation of a market-based economy in Albania and a return to external viability. Beyond this first bold step lies a longer-term task. Therefore, I welcome the authorities' intention to move on to an ESAF program, which would provide an appropriate framework to advance and deepen the process of structural adjustment and reform.

The financial policy objectives of the program are ambitious, and rightly so. But a number of risks come with such ambition, and the authorities will need to be vigilant and responsive to developments as they unfold. Fiscal policy is the key nominal anchor of the program, and the programmed sharp reduction in the domestic bank financing of the budget is essential to the authorities' effort to reassert control over monetary and credit aggregates. In the short run, the greater burden of fiscal adjustment has, by necessity, fallen on expenditures. Accordingly, the authorities should make every effort to exercise effective budgetary control, especially in the area of enterprise subsidies, to achieve the sizable spending cuts. They must also resist pressures to ease spending. Against this austere backdrop, I welcome the retargeting of the social safety net to the most needy.

Beyond the short run, a sustainable budget position, which would be less reliant on external financing, requires a fundamental restructuring of expenditures and a reform of the tax system. These changes are essential, if fiscal consolidation is to be achieved, while new additional budgetary burdens associated with financial and agricultural sector reforms are accommodated. The authorities are to be commended for making tax reform an early priority, which should reap some benefits in 1992, but more so in 1993.

The task of monetary and credit policy has been severely complicated by the disruption experienced in the monetary and institutional fabric of the economy. Nevertheless, it is clear that the objective should be a firm reversal of the trend toward hyperinflation. As to the conduct of policy, in view of the uncertainty about the demand for money, the exchange rate could prove a useful indicator of the stance of policies, despite the small size of the foreign exchange market. I would welcome the staff's views.

To control the growth of credit and monetary aggregates, the authorities will need to rely on simple direct controls because of the weak state of the banking system. Moreover, ensuring that interest rates are positive in real terms will be important. However, where possible, every effort should be made to mimic market forces and encourage the introduction of a commercial and competitive banking system. In this respect, I welcome the fact that bank-specific credit ceilings are tradable and the introduction of indicative "guiding rates." I would appreciate an explanation of how these "guiding rates" will operate. However, to avoid the emergence of wide interest rate spreads and encourage competition, an expansion of the deposit base to all banks will be important. Also, the authorities should monitor closely financial relations among the banks and enterprises to avoid the circumvention of financial policies by arrears and unwarranted new credits.

On price reform, I was dismayed to discover in the staff report that the tax inclusive wholesale price of light fuel oil--an important intermediate input--had been increased by 400 percent to a level approximately double that of world prices. This increase could only be a recipe for disaster, which would throw cold water on any supply response striving to emerge in an environment of severe contraction of domestic demand. In fact, I understand that this increase has indeed created difficulties for producers, although, to some extent, it has been mitigated through fuel purchases outside official markets. However, I am glad to observe from the staff's opening statement that this episode will end on a positive note, and the staff has not stood in the way of a downward correction in the prices to more reasonable levels.

On a related point, I welcome the fact that in Table 4 of the staff report, the benchmark for making comparisons of energy product prices includes not only Europe--an exceptionally high petroleum tax region--but also the United States. Nevertheless, in describing energy pricing policy, it would be instructive if the staff would show price levels and ratios, including and excluding taxes.

The authorities have sensibly focused their structural reform efforts on a few critical areas. The privatization of agriculture should yield a significant positive output relatively quickly, which will help alleviate domestic food shortages and contribute positively to the current account position. Of particular note in this area is the separation of ownership and compensation issues, which should add productive certainty to farmers' planning horizons.

As regards the privatization of state enterprises, the authorities have sensibly established some sectoral priorities, while creating the legislative base for an inevitably more gradual, broader restructuring effort. Here, I welcome the close collaboration between the authorities and the World Bank, and the progress already made in the retail distribution sector. However, while a revised enterprise reform law was approved in July 1992, I note that the introduction of a bankruptcy law is still pending. I encourage the authorities to approve this law as soon as possible, for without a clear bankruptcy framework, creditors and debtors will be hesitant to initiate proceedings, thereby stalling the restructuring process.

In view of the exceptionally difficult point from which the authorities' reform efforts are starting, it is not surprising that the external outlook presents a commensurately difficult challenge. In the case of Albania, it is clear that, while the patient must undoubtedly undergo some self-administered surgery, it is also in need of some externally provided medicine and support--both technical and financial. Indeed, to attain not only their own domestic reform objectives, but also to attract critical and much-needed external support, the authorities will need to demonstrate for many years to come a firm commitment to their goal of stabilizing and transforming the economy. In particular, I encourage the authorities to reach a speedy resolution to their financial relations with commercial bank creditors. Repeated debt rollovers accompanied by the accrual of unpaid interest will only exacerbate an already difficult situation.

The Albanian authorities have embraced a daunting challenge with a sense of purpose and a prudent realization of their own capacity to act. This determination has led them to a radical and pragmatic course of action, which deserves our support. There are risks and uncertainties in the tasks that lie ahead, and the authorities will have to follow their bold start with perseverance.

Mrs. Szombati made the following statement:

Albania's situation is the most difficult among the Eastern European countries in transition. The launching of the social and economic transformation of this isolated, strongly regulated, and poor country has been attended by social unrest, public disorder, and complete economic collapse. Albania's already deep poverty is worsening, its external debt burden is becoming unsustainable for lack of external resources, the collapse of agriculture requires emergency food aid, and shortages of spare parts and primary inputs are decreasing capacity utilization and closing state enterprises.

The new Government is faced with two enormous tasks at once. It must quickly restore public order and government functions, while simultaneously launching a market-oriented restructuring and stabilizing of the economy. It is clear, however, that re-establishing the political and economic stability, reforming the economic environment, and correcting the weaknesses caused by past mismanagement of the economy will take many years. Both a strong commitment to structural and stabilization policies and continued financial assistance from abroad will be needed.

We fully support the Government's immediate strategy aimed at halting the economy's slide, avoiding hyperinflation, and commencing to liberalize prices and the exchange and trade system. We commend the impressive prior actions that demonstrate the authorities' commitment to the planned economic program and can agree with the staff's view that its policies represent the best effort possible under present circumstances. Nonetheless, we are extremely concerned about the exceptional risks and uncertainties facing the program from the unstable social and economic situation and the lack of market institutions and expertise. Our approval of the present stand-by agreement is thus based in large part on our confidence in the Government's commitment.

As to the details of the program, we generally agree with the Government's priorities and its planned policies. I will comment briefly on financial stabilization, structural reforms, and the external sector. Fiscal policy will be the key to the Government's stabilization efforts. The planned large reduction in the deficit faces exceptional uncertainties, because the disappearance of the traditional tax base forces it to rely heavily on expenditure cuts at a time of severe social tensions. Shortfalls in grant receipts would also create serious problems. The staff notes that the fiscal program calls for a large adjustment with steep reductions in real expenditures over the next 12 months. The significant cuts in subsidies and military spending are especially welcome. Income restraint in the state sector and the streamlining of the social security system will also be crucial for achieving the fiscal target. Fiscal consolidation over the medium term will require additional strong measures, including restructuring the public finances, modernizing the tax system, and completely overhauling the structure of expenditures. The first steps toward these goals have already been taken with the recent adoption of tax and other revenue measures.

Stabilization will require speedy restoration of control over enterprise behavior and assistance to viable enterprises. Fundamental restructuring and improved financial performance are essential if subsidies are to be replaced with the production of taxable income as soon as possible. These actions can be achieved by hardening enterprises' budget constraints and restraining their wages. In the monetary area, policy implementation must be strict--a difficult task, given the undeveloped state of the financial system and the lack of efficient monetary instruments. Especially useful is the recent strengthening of the central bank and its instruments, but there is still a need for credit ceilings and control over interest rates until the financial system reforms are in place. A two-tier banking system is urgently needed to allow for an independent monetary policy. Its establishment should include the adoption of new banking laws and prudential regulations to provide clear, well-defined rules of play for new commercial banks.

The structural reforms are clearly urgent, as shown by the serious distortions revealed by the collapse of the central planning system's coordination mechanism. As Mr. Filosa points out in his opening statement, the authorities decided to adopt a strong shock therapy approach to economic recovery, recognizing that the existing productive and administrative structures would not have responded to a gradual approach. The basic first steps have already been taken toward establishing market mechanisms by the prompt liberalization of the exchange and trade system and price and trade reform. To obtain the expected supply results of comprehensive price and trade liberalization, the authorities should also accelerate steps to put basic institutional elements of market-based resource allocation in place. Urgent structural reforms should include enterprise restructuring and, especially, the closing of unviable units. Special efforts must be made to foster private initiative. The development of the entrepreneurial spirit can best be pursued by beginning with the privatization of small-scale enterprises to replace the collapsed official distribution network.

The agricultural sector should be encouraged to reverse the rapid decline in output. Here the supply reaction will require not only price liberalization, but also legislation to permit private ownership of land and to settle former owners' claims. The authorities should give high priority to the creation of a basic legal and institutional framework for private ownership that will facilitate the participation of the private sector, both foreign and domestic, in the reconstruction of the economy. Because structural changes and systemic reforms cannot be accomplished overnight throughout the economy, we endorse the Government's intention to develop a medium-term program of structural reforms to be supported by further Fund assistance. And generally, given the exceptional problems of Albania's rigidly planned economy in making the transition to a market system, we feel this program should give more emphasis to structural performance criteria, even though restructuring is not the purpose of a stand-by arrangement.

Albania has serious balance of payments problems reflecting the collapsed state of the economy and the severe financing constraints. It is especially unfortunate that large trade imbalances have stretched into the medium term owing to the very slow recovery. The staff notes that Albania could achieve viability by boosting its traditional exports with the help of foreign investments. Given the relatively skilled and low-cost labor force, developing manufacturing capacity and diversifying exports seems equally as important in offering better long-term prospects. I would like to know more about the authorities' long-term development plans.

It is clear that Albania will need substantial amounts of exceptional financing during the next several years to support recovery and maintain external viability. The staff notes correctly that the only way of filling the gaps projected over the medium term is by grants and highly concessional assistance from the international community. Albania's exceptionally weak external payments position makes it essential to attract nondebt-creating investments. Normalization of relations with creditors is an important precondition for both attracting investment flows and smoothing access to supplier credits, and the authorities should speed their efforts to find an appropriate resolution of their huge external indebtedness. In this connection, I would be interested to know the most recent developments in negotiations with the commercial banks and the staff's assessment of the chances of achieving the necessary agreement. With these remarks, I support the proposed decision.

Ms. Creane made the following statement:

Reading through the documents supporting Albania's request for a stand-by arrangement brought to mind the first staff reports from the initial Fund membership missions in early 1991. The descriptions we heard then of the primitive economic situation and stark social conditions encountered were astonishing. As the closest example in memory of complete autarky, it was, by negative example, a potent reminder to all of us of the benefits of a market trading and economic system. And yet, since that time, Albania has suffered further massive economic deterioration, with GDP dropping steeply and inflation accelerating.

As a result, Albania's starting point as it embarks on a program of economic adjustment, is exceptionally low, as illustrated quite "graphically" in Chart 1. That the weak starting point is due to the convergence of unusual conditions does not allow for easy consideration of experience elsewhere to assist in guiding decisions on policies, priorities, and sequencing. Yet, the proposed stand-by program, notwithstanding some substantial risks, reveals the political decision and will to move ahead forcefully to stabilize and reform the economy in Albania. In our view, the proposed stand-by program should be successful in reaching the first plateau in achieving those goals, and it deserves broad Board support.

We are impressed with the first round of policy actions completed this month. The freeing and upward adjustment of prices will give greater latitude to the workings of the market mechanism, reduce fiscal subsidies, and assist in demand management. The tough incomes policy under way, which will result in a sharp decrease in real wages, has a similar importance in the overall program. In the next months, pressure is likely to rise for a reversal of these and other actions, which we strongly encourage the authorities to resist. The steps taken to liberalize the exchange and trade regime are also important and of a caliber yet to be followed by many another Fund member. We look forward to a schedule detailing the phasing out of the remaining price and trade restrictions as soon as feasible.

The fiscal deficit planned for the second half of 1992--19 percent of GDP--is still rather high. But the deficit and the domestic bank financing component are substantially smaller than in 1991 or in the first half of 1992. Further, the potential for achieving this goal is relatively strong, given that the budget has already been passed by the Albanian Parliament. The fiscal targets for 1993 are also still large, and we are particularly concerned about the deficit financing projections that include a 10 percent of GDP monetization target.

While the halving in real terms of expenditures this year is significant, there should be room, albeit painful to implement, for additional expenditure cuts beyond those projected next year. Exceptionally critical to the overall fiscal effort is the maintenance of the end to state enterprise subsidies and payments to idle laborers. Any backtracking on these measures would unravel the ongoing fiscal efforts. The revenue projections for 1993 seem rather pessimistic, given the new tax measures under way and the stabilization of output that is projected. We would strongly encourage the Albanian authorities to give priority to dramatically improving tax administration as the key to further whittling away the continuing large fiscal deficits.

The monetary policy options available to the Albanian authorities are rudimentary at this stage, given the existing nascent status of the financial sector. We were encouraged with the initial measures already taken, including changes in the interest rate structure and introduction of a reserve requirement. With time, these steps, along with completing the establishment of a competitive commercial banking sector, will assist in moving away from credit controls to indirect policy instruments. However, interest rates are still deeply negative in real terms, and, although the staff notes that they are already having an allocative effect, we would encourage more rapid movement than currently planned to positive real rates, including the central bank refinance rate. In the meantime, the authorities are encouraged to be highly flexible in interest rate management.

Recapturing control of the state enterprise industrial sector stands out as an immediate problem for the adjustment program. Massive restructuring and privatization of that sector would be a close second priority. Most state-owned enterprises created by 40 years of autarkic central planning are not economically viable. Therefore, we would suggest that Albania concentrate on removing impediments to the creation of small businesses and resist pressure to prop up essentially defunct state enterprises. It is essential, therefore, to put in place quickly the legal and institutional framework that underpins any private sector. Although it is not likely to be achievable in the near term, a thriving private sector will eventually help to absorb the expected increases in unemployment. We fully support the authorities' plans for short-term handling of the public enterprise problem as described in Appendix IV, including the cutoff of easy credit, the cessation of subsidies, the provision of technical assistance, changes in management practices, and the implementation of measures to address the emerging interenterprise arrears and the existing large level of bank debt.

We welcome the frequent program reviews proposed by the staff as critical for monitoring and assisting in program implementation in Albania. For this reason, we are pleased that a resident representative is finally in Tirana. The staff report uses the word "radical" to describe the systemic reforms necessary for long-term viability in Albania. We absolutely agree that a dramatic transformation is in order. The steps taken to date are a strong start by the Albanian authorities, and we look forward to considering expanded efforts for 1993 at the time of the first review.

Mr. Dognin made the following statement:

We are considering this request under special circumstances. First, the Board is dealing with Albania's economy for the first time, and I warmly welcome this initial opportunity. Second, the prompt shift from a wholly centralized and autarkic economy to a market-based one is rather "exceptional"--as the staff puts it--and this shift renders the task of arresting the rapid and profound deterioration of the economic situation even more difficult.

Despite the measures recently taken by the authorities, the GDP will fall further in 1992. Prices are expected to rise at an average of 280 percent, and the current account deficit will probably double, reaching nearly $500 million. In the context of such financial imbalances and such a challenging move toward an open and market-based economy, Albania's efforts warrant the support of the whole international financial community, particularly the international financial institutions. Although it can only be the first step toward macroeconomic stabilization, I fully share the staff's view that this one-year program and the impressive set of prior actions adopted by the Government provide the appropriate framework for such international support.

Turning now to the program itself, I have little to add to the comprehensive staff report. Measures needed to attain the early stabilization of the economy are, indeed, or will shortly be, in place. Medium-term economic consolidation will nevertheless require the adoption of additional difficult policies and further support from the international community.

First, one cannot overemphasize the dramatic changes recently implemented by the authorities. The substantial price adjustment and deregulation that have taken place should contribute to stimulating the supply response. Exchange and trade liberalization has been swiftly implemented and is the basis for an early recovery, especially in the agricultural sector. If implemented as targeted, the budget for the second half of 1992 provides for a sharp cutback in expenditures in real terms, namely, in wages and subsidies, which will affect prices and enterprises. Especially crucial will be the imposition of hard budget constraints on public enterprises.

These strong demand-tightening measures, which certainly constitute, as stressed by the staff, only the first step is a long process, will have to be accompanied by close monitoring, especially of monetary developments. In this respect, I can concur with the staff, first, that flexibility will be needed in the conduct of monetary policy and second, that credit ceilings will play an important role in controlling monetary aggregates, given the limited effectiveness of the interest rate policy in the first place.

There are considerable risks and uncertainties in this strategy, stemming especially from the limited experience of the public administration in market-based mechanisms. I do agree, however, with the staff that, for the time being, the authorities could hardly advance the reform process any further than they have without placing too much hardship on the population and jeopardizing the political consensus toward reform.

In this respect, I particularly welcome the support that the World Bank will provide in designing a social safety net better targeted to the most vulnerable part of the population. In addition, such an overhaul of the social security scheme and unemployment benefits is indispensable in reducing the overall budgetary costs of the safety net which--at 16 percent of GDP for the second part of 1992--is clearly too high to make room for other priority expenditures, such as much needed infrastructure investments and state enterprise reform.

Among the many urgent structural reforms that are to be addressed by the authorities, agriculture deserves special emphasis, given its potential for a quick recovery and the fact that almost 50 percent of the population derives its livelihood from this sector. Henceforth, the privatization of land now part of cooperatives must be completed, the restructuring of state farms undertaken, and amendments to the Land Law passed as soon as possible, so that the legal framework for the activities of economic agents is firmly established. Furthermore, extension services to the rural sector and institutional capacity building are, in my view, two important areas where Albania could greatly benefit from the experience of international institutions like the World Bank.

As to the external sector and financing assurances, Albania will clearly require over the medium term substantial concessional external financing for food and for budgetary and technical assistance. In my authorities' view, such a high level of financing requirements calls for a more equitable burden sharing among G-24 countries. Moreover, the debt to export ratio--amounting to 840 percent in 1992--points to the severe indebtedness of the country and the need for Albania to seek an agreement with its commercial creditors.

Concerning Fund support, this program, if faithfully implemented, will lay the groundwork for a medium-term program that could be supported by an ESAF arrangement. I am pleased to note that work has begun on a medium-term policy framework. A close monitoring of the policies and reform process being also critical to the success of the program, I welcome the appointment by the Fund of a resident representative in Tirana.

To conclude, I would like to commend the Albanian authorities for the comprehensive and challenging reform process upon which they have embarked, and I encourage them to implement in a timely manner the measures set forth in the program. This is a prerequisite to arrest the ongoing deterioration of the economy and thus gain the international financial support that they need and to enable the Albanian economy to build upon the current consensus for reform and use its potential resources fully. I approve the proposed decision.

Mr. Finaish made the following statement:

The staff has produced a candid and forthright report on the exceptional economic difficulties facing the Albanian authorities. As a starting point for reform, Albania's situation could hardly be worse. Against a background of severe economic, social, and administrative disarray and an economy in a virtual free-fall, the task of stabilizing the situation and building the foundations of a market-based system is truly daunting. Notwithstanding these circumstances, the authorities' decision to undertake a dramatic domestic policy effort involving strong prior actions is a highly commendable one.

To be sure, the program faces--in the staff's words--"exceptional risks and uncertainties," and, even in the best of circumstances, one could expect only a gradual return to macroeconomic stability. Output could well fall further before stabilizing, and real wages could be expected to continue their inexorable decline--thereby heightening the growing sense of deprivation--while unemployment in the industrial sector could reach a staggering 50 percent of the labor force. However, in the case of Albania, perhaps the strongest element of the program is that it is being launched in the context of favorable domestic political conditions and a strong consensus for change. By the same token, it is important that this opportunity for comprehensive change not be lost.

In general, one can agree with the key policy issues raised in the staff appraisal and, in particular, with how crucial concessional external support and a satisfactory resolution of the commercial debt problem will be to the success of the authorities' own efforts. I would like to make a few comments on selected aspects of the program. First, in the area of fiscal policy, it is clear that fiscal consolidation will play a central role in the stabilization and restructuring effort. Given the revenue constraints, most of the adjustment will have to come from a sharp cutback in expenditures. However, I was somewhat disconcerted by the sharp cutback in investment expenditures being contemplated and the likelihood that this decline would continue for several years. I am not sure whether it is possible to reconcile this drastic compression in investment with the need to nurture and sustain a vigorous supply response, especially in the agriculture, mining, and mineral sectors. Comments by the staff on this issue would be appreciated.

On the outlook for the external account, it appears that the speed at which the trade deficit can be brought down is a function of the response of the agricultural sector, and in particular, the recovery of domestic food production. Assuming that such a response is forthcoming, the decline in food aid may not yield the counterpart funds to support essential government expenditure. What assurance is there that the tax administration will be able to raise revenues to compensate for the fall in counterpart funds over the 1992-96 period? The staff's comments would be welcome.

A word about exchange rate policy, the centerpiece of a comprehensive exchange system reform: one can agree that the strategy being followed risks volatility, but there is, perhaps, little alternative to it, given the difficulties associated with targeting an appropriate exchange rate and the absence of official foreign exchange reserves. It appears that immediately after the floating of the rate, the lek was trading in the range of 115-125 per US dollar. Perhaps the staff can update the Board on recent movements in the exchange rate. It would provide a good early indication of the effectiveness of the authorities' financial and incomes policies.

In the area of price liberalization, the authorities say that being concerned about social tensions, they have deferred full liberalization of key food prices, even though the new controlled prices have been raised substantially. I wonder whether consideration was given to adopting a "dual system," whereby all prices would have been liberalized fully, but concurrent with providing a target group with a minimum subsistence basket of goods at fixed prices. Such a system would eliminate the need for price controls and reduce the possibilities of abuse of the system.

The authorities expect to take steps to encourage the creation of new private firms. Many private businesses, particularly in the retail trade, have been formed during the past six months. But the authorities will need to adopt measures to promote private sector investment throughout the economy, including the encouragement of foreign private investment. The success of the authorities in attracting long-term investments in the private sector--an essential ingredient of the transition to a market-based economy--could be adversely affected by the possible spillover effects of the continued political turmoil on Albania's borders.

Finally, it is my hope that the successful completion of the present stand-by arrangement will pave the way for a successor arrangement under the ESAF, so that Albania's transition to a market economy can be placed in an appropriate medium-term setting.

Mr. Ismael made the following statement:

Albania's moves to pursue policies of macroeconomic stability and systemic reforms, such as those outlined in the Memorandum of Economic Policies, are commendable. Indeed, the Albanian economy, with its highly unstable domestic demand and precarious external payment situation, requires a new direction in domestic policy in the real sector as well as the financial sector and substantial foreign financial and technical assistance. Domestic policy efforts should be geared toward the stabilization of output, a drastic reduction in inflation, and the protection of low-income groups through the expansion of the social safety net. I, therefore, concur with the authorities' intention to emphasize an early revival of the agricultural sector. I hope that this move will give a quick supply response that could prevent the danger of a food shortage, reduce unemployment, and ease the necessary outlays of the social safety net program.

In view of the depleted capital stock in virtually all sectors of the economy, I would suggest that replacement of capital stock in the agricultural sector, such as the construction or restoration of dams and the irrigation system, be given first priority. At the same time, the implementation of the privatization program for the agricultural sector, which includes privatization of large state farms, should be expedited. The Land Law also needs to be amended, so that new owners can sell their land or use it as collateral when they need bank credits to increase production. Similar reform programs could also be carried out in other sectors of the economy at a later stage to facilitate the distribution mechanism and further enhance the level of competition.

The implementation of these important structural reforms is crucial not only to the imminent task of stabilization, but also to the medium-term economic recovery. It will also pave the way for medium-term export recovery, support a floating exchange rate regime, and foster prudent management of the financial sector. It is, therefore, desirable that a start be made in drafting a plan to privatize larger enterprises, which would include a financing plan that would open up the possibility of foreign investment to ease the financing needed for privatization and promote entrepreneurship among local industrialists.

For the accommodation of shortfalls in programmed external financing and in view of the huge financing gaps predicted over the medium term, a stringent fiscal and income policy stance is necessary. It is, indeed, unfortunate that, during this transition, the central government budget deficit for the second half of 1992 is still so large. At the time when social safety net needs are the greatest and economic activity and the yield from new tax measures are still weak, the sharp declining trend in the revenue to GDP ratio--caused, in part, by the disappearance of the traditional tax base, owing to the closure of many state enterprises and the breakdown of tax discipline in the state enterprises still in operation--is a cause of concern.

In the meantime, the planned revenue enhancement measures, amidst the gloomy outlook for economic activities, will not produce a large revenue increase quickly. Drastic measures to reduce budgetary outlays through, for example, termination of salaries to idle workers, deep cuts in military expenditures, strict control of wage increases, and a hiring freeze are commendable. In this respect, I welcome the authorities' plan to limit the use of domestic bank financing and, instead, use the counterpart funds associated with external grant assistance. These heroic reform efforts by the Albanian authorities deserve the full support of the international financial community. With these observations, I support the proposed decisions.

Mr. Clark made the following statement:

Other speakers have already emphasized the Albanian authorities' daunting task--the stabilization and reform of an economy that has virtually none of the institutional infrastructure that is necessary for a market economy. As such, our task of assessing the adequacy of the program before us today is difficult. As highlighted in Mr. Filosa's opening statement, the authorities are to be commended for having implemented significant first-step measures required to begin the process of releasing the economy from its autocratic roots. In a second-best world, the program envisaged by the authorities is probably the most one could expect under the current circumstances. Because the program is ambitious and is being implemented without an adequate institutional framework and with limited knowledge of the key economic relationships, one can only be concerned about the exceptional and enormous risks that surround the program.

In these circumstances, even if the authorities pursue reform relentlessly, it may be difficult to achieve even the first set of performance criteria. Although a stand-by arrangement appears somewhat inconsistent with the staff recommendation that lending to Albania be on highly concessional terms, it will provide a framework to monitor and consult frequently with the authorities. This provision should expedite the process of developing a medium-term program to be supported by an ESAF arrangement.

As most of our specific reservations of the stand-by arrangement for Albania have been addressed by the previous speakers, I will confine my remarks to two key concerns, which, while relevant to today's discussions, also pertain to future requests for programs by members confronted with similar economic and institutional situations.

The first concerns the authorities' ability to monitor and control policies. The Board has highlighted, in its previous discussions, the symbiotic relationship between macroeconomic stabilization efforts and the implementation of structural reforms for countries in transition to market economies. Fundamental to this principle is that to successfully stabilize an economy, the authorities must have a sufficient degree of social consensus backing their efforts and, equally important, the administrative capability to implement and monitor their policies. While the Albanian authorities are supported by an impressive electoral mandate, given the initial starting conditions, their ability to effect their policy objectives is severely impaired by the lack of a fiscal administrative structure and a solid financial system in which to implement and to monitor their policies. As a result, we can only be skeptical that the objectives for fiscal and monetary policies are, in fact, achievable.

On the fiscal side, the projected 30 percentage point improvement in the deficit for the second half of 1992 is admittedly impressive; still, at 19 percent of GDP, the budget deficit remains excessively large. We would argue that such a large reduction in the deficit may prove to be overly optimistic. For example, the projected reversing in the trend for government revenues is at particular risk.

The scope for raising tax revenues may be even more limited than envisaged, as customs duties and excise taxes can be difficult to collect without a comprehensive system to enforce compliance. In addition, we would question as a reliable revenue source the 6 percent levy on enterprises to partially finance spending on the social safety net.

The authorities have therefore--rightly, in our view--focused their attention on reducing expenditures. However, the system with which to monitor expenditures is, as the staff notes, "seriously deficient in the absence of treasury functions at the Ministry of Finance." It was, therefore, somewhat reassuring to see that the authorities have allocated roughly 3 percent of GDP in a contingency reserve to cushion against any slippages.

There are also clear and sizable risks associated with the monetary policy aspects of the program. The staff points to the Bank of Albania's role in providing a key nominal anchor for the authorities' program, yet it also notes the uncertainties of the underlying assumptions and the untested nature of the banking system. While we agree with the staff that the central bank will need to exercise flexibility in implementing monetary policy and would encourage the authorities in that respect, we may be asking more from the monetary authority than it can realistically deliver.

The second issue of concern we would like to address is the financing gaps projected for 1992 and 1993, which, perhaps more than other speakers, we find particularly disturbing. It was our understanding from the briefing note to the G-24 provided by the staff that "for the IMF to be able to support the authorities' program with its own resource, it is necessary that the requested additional food aid and the balance of payment support for the second half of 1992 be fully approved." From Table 9 of the staff report, this prerequisite appears not to have been attained. Although the report indicates that the authorities are reasonably confident of obtaining the necessary financing assurances, the staff' comments on what contingency measures would be taken, should this gap not be filled, would be welcome.

In 1993, the size of the financing gap projected is also unsettling. Although the staff has assumed that Albania will come to an agreement with its commercial creditors and receive substantial debt relief, it notes that, given the large size of the external debt relative to the country's ability to pay, resolution is likely to be protracted. This expected delay would imply that the financing gap outturn may be even larger than projected, and it highlights the risk to Albania's medium-term viability and, therefore, its capacity to repay the Fund.

We can support the request for the stand-by arrangement, because, as Mr. Filosa says "there does not appear to be any real alternative," but as the tone of my statement has underscored, given the enormous risks involved, we have serious concerns that, come November, the program will not have gotten on track. Nevertheless, the authorities have conveyed their commitment to reform and their determination to implement a tough adjustment program. It is true that at the present time the authorities enjoy broad social and political support for the reform. I hope that this needed support proves durable in the difficult period ahead.

To sum up, the staff has once again been faced with having to design a program that attempts to balance economic adjustment and available external assistance, while at the same time hoping to maintain some degree of social and political support. In Albania's case, the emphasis placed on economic adjustment is necessarily substantial and the associated risks are large, as external financing remains uncertain and there exists virtually no institutional foundation on which to begin a process of reform. The implications for maintaining the needed social and political support should be obvious to everyone. As we all know, we will be confronted in the near term with requests similar to that of Albania. The challenge for the authorities, the staff, and this Board is to find that delicate balance of adjustment and external assistance that will maintain the social and political support for reform over a long and difficult period.

Mr. Nakagawa made the following statement:

Like other speakers, I welcome this opportunity to discuss the first request by the Albanian authorities for a stand-by arrangement. Given the difficult economic situation that the country faces, the steps and measures already taken by the authorities are remarkable. In particular, decisive actions to liberalize prices and adjust remaining controlled prices are highly commendable. I was encouraged by the authorities' bold attempts to liberalize most of the trade and exchange restrictions at such an early stage in the transformation of the economy.

As the staff notes, however, the task for the authorities is monumental. And Mr. Filosa is right in saying in his opening statement that the achievement of such a task will not be possible without support from the international community, especially the Bretton Woods institutions. It is in this spirit that this chair supports Albania's request for a stand-by arrangement and encourages the authorities to continue the efforts to stabilize, transform, and revive their economy.

The most urgent task for the authorities in stabilizing the economy is to reduce the fiscal deficit. Strict implementation of the measures envisaged in the program to cut fiscal outlays is by far the most important in the immediate future. Key in this respect is the effectiveness of the incomes policy. Because the incomes policy is virtually the only anchor in the program for the stabilization of the economy, the authorities would need to persevere firmly with the objectives of the incomes policy. In this connection, it is encouraging to note in Mr. Filosa's opening statement that the authorities have introduced tax-based sanctions for the violation of wage increase limits to ensure the effectiveness of the incomes policy.

On the revenue side, given the collapsed real sector of the economy, there is currently not much room left to squeeze more tax revenues. Nevertheless, I would like to stress that it is important to start now to explore the possibility of a future comprehensive tax reform that would lead to the establishment of a broad-based tax system. The necessary steps are already being taken by the authorities.

Recovery of the real sector of Albania's economy is also urgent if the fiscal balance is to improve. Recovery of the supply side is, indeed, needed. I highly commend the authorities' strategy to make the agricultural sector the core for the recovery of output, putting priority on agrarian reforms, including land reforms. I wonder whether the World Bank has any plan to provide agricultural sector reform loans to Albania; sectoral reform loans from the World Bank group are the kind of financial support that Albania most needs at this stage. I would appreciate the staff's comments. It is encouraging to know that the reforms in this sector are rather advanced when compared with other Eastern European countries, particularly those for distributing land to individual farmers.

To make the agricultural sector a driving force in the economic recovery, however, it is absolutely necessary to give more incentives to individual farmers by granting comprehensive land rights. This means land owners must be able to sell, buy, or lease the land. They also must be able to use the land as collateral. Without these reforms, land cannot be a source of capital for farmers in its true sense. I urge the authorities to proceed expeditiously with amendments to the Land Law.

Frankly speaking, the staff's medium-term projection seems to be on the optimistic side. Even if the agrarian reforms are successfully implemented, it would seem difficult for Albania to achieve 3-4 percent real output growth, together with an annual 15 percent growth in the value of exports in the foreseeable future. I recall that even other Eastern European economies, which had better initial economic conditions, were not able to achieve a similar export growth rate.

In addition, I was rather surprised by the staff's frankness when they say in the staff report with respect to the country's capacity to repay the Fund, "on the whole...there are clear risks for the Fund." I am also concerned about the fact that the program is yet to be fully financed--that is, there is not full financing assurance. It is regrettable that we have to treat this program in an exceptionally flexible way in terms of financing assurance and in the assessment of Albania's ability to repay the Fund.

Given these shortcomings and Albania's limited institutional capacity, Albania's most pressing need at this stage is the provision of intensive technical assistance by the Bretton Woods institutions and project-based financing provided by the World Bank group. In view of its concessionality and medium-term framework, an arrangement under the ESAF would be more advantageous than a stand-by arrangement at this stage. Therefore, I would like to urge the authorities and the staff to expedite the steps needed for the formulation of an arrangement under the ESAF for the medium term. With these comments, I support the proposed decision.

The staff representative from the European I Department said that the exchange rate had been a useful summary indicator of the tightness of financial policies in other Eastern European countries with floating exchange rates. The recent appreciation of the lek from 130 to 100 to the U.S. dollar could, thus, be an indicator of the initial tightness of policies. However, it took time to build a broad and representative interbank market, and the market in Albania was currently extremely thin. In time, it would become an important indicator.

For the first half of the program period, with a financing gap of about $65 million, the staff had provisioned about $15 million as a possible initial payment to commercial banks, should the authorities reach an agreement with them, the staff representative explained. However, in the event that such an agreement did not materialize in the first half of the program period, that $15 million payment would not be made. Therefore, the financing need in the first half of the program year would be correspondingly less.

For 1993, the European Commission was prepared to consider a second tranche of about the same amount that it had recently approved for the first half of the program year--ECU 35 million, or $44 million, the staff representative continued. Nevertheless, a large financing gap would remain. It was hoped that the G-24 would make commitments toward covering it. The floating exchange rate was one automatic adjuster. Reserves were another. However, the program specified a minimum level to which gross reserves must be raised; therefore, only a limited margin was available from that source. In view of the program's high risks, any shortfalls in financing would seriously jeopardize the achievement of the program's objectives, although there was a contingency in the government budget, and the staff and the authorities could again review the components of the 1993 budget.

As to the medium-term projections for export and GDP growth, the volume of exports was now much lower than in the recent past, the staff representative remarked. Therefore, the projections assumed a return to export levels of only a few years ago. Until recently, Albania had been a net food exporter, although the prospects for agricultural exports would depend on the extent of their access to the European Community. Albania had considerable natural resources. It was still the third largest producer of world chromium; it also mined nickel and other metals. Tourism was an untapped potential. Therefore, there were some elements of strength in Albania's long-run growth prospects. However, the program was only just beginning, and the medium-term projections would be reviewed when the medium-term program was being formulated.

There was no early prospect of a breakthrough with commercial banks on a resolution of Albania's external debt, the staff representative indicated. Both the short-term nature of the indebtedness and its size, coupled with the banks' reluctance to make a concerted effort to meet to discuss it, made it problematical. The authorities were trying to arrange a meeting between their new negotiator and the banks. Because of the debt problem, Albania faced a financial isolation that could cripple its recovery. Even the passage of regular funds through banks was already proving to be a problem.

Public investment had fallen to a very low level, partly because the Government had simply stopped providing transfers for fixed investments by enterprises, the staff representative said. Nevertheless, the program provided for a small increase in the public investment ratio next year. However, it would take a long time for Albania to rebuild institutions and its capacity to implement investment programs. The authorities were working with the World Bank in that connection.

Regarding the medium-term outlook for the public finances, tax administration and tax policy would have to compensate for the potential loss of food counterpart receipts, the staff representative stated. A large technical assistance program, in which the Fund played a leading role, was being launched. That program had led to Parliament's passage of important amendments to existing laws and of new legislation affecting a wide range of domestic taxes, including excise, turnover, profit, and income taxes. A new law on tax administration had also been passed. A customs law was expected to be approved in a few weeks. The program provided for an initial increase in the tax ratio equivalent to 3 percent of GDP. It would take several years to improve the revenue side of the budget. In the meantime, expenditure control would have to be a key instrument.

A stand-by arrangement had been unavoidable, owing to the shorter time interval it took to institute, but it was a costly instrument for Albania, the staff representative from the European I Department remarked. The staff and the authorities were working toward a medium-term program under the ESAF to be ready, if possible, for spring 1993. An ESAF arrangement would be much better suited to Albania's circumstances.

The Chairman said that he agreed with the speakers urging acceleration of the ESAF arrangement negotiations to limit, if not to eliminate, the expense to Albania of financing by means of a stand-by arrangement.

Another staff representative from the European I Department explained that the guiding rates for interest rates were lending rates set by the central bank for the key maturities on commercial bank loans, in the range of 25-39 percent for instruments from 3 to 12 months. Those rates were guideposts used in the regular consultations between the central bank and the commercial banks. In fact, only last week the central bank had, for the first time, held a meeting of a newly established interbank committee, which could focus on such issues. The consultations would be based mostly on the spreads that individual banks wanted to charge on their loans, taking into account the different cost structures and customer bases of each bank.

As to the possibility of installing a dual system of prices for certain products, there was in fact a dual pricing system for certain food aid items, the staff representative from the European I Department remarked. Those items--if received from foreign donors--were being sold at controlled prices, but--if coming from other sources--they could also be sold in private markets at market-determined prices. However, on some core essentials that the Government considered of critical importance for the subsistence of the poorer segments of the population, prices were fully controlled, because experience had shown, especially in Albania, that where a dual price system had existed prior to recent decisive reform, the controlled segment of the market had dried up completely. Although the controlled segment had been targeted to the most vulnerable, it was simply not available to them because of leakages to the free market.

The staff representative from the Policy Development and Review Department stated that a G-24 financing network had been formed and was expected to meet in early September. There were indications that some balance of payments support would be forthcoming. Under the assumption that the debt problem with commercial banks could be resolved, the financing gap would be small and any modest support would be helpful in closing that gap for the second half of 1992. Likewise, the gap for the first half of 1993 would depend on how fast the problem of commercial bank debt could be resolved.

The stand-by program included quarterly financial reviews, and progress would be reported to Directors, the staff representative said. Satisfactory progress in making adequate funds available to Albania to close the financing gap would be needed to complete the first program review.

The buildup of reserves in 1992 was rather ambitious, given Albania's starting position, and a further buildup in the first half of 1993 would provide some cushion, the staff representative from the Policy Development and Review Department commented. The 1993 target for buildup of reserves was even more ambitious than the 1992 one.

The staff representative from the European I Department said that the World Bank was already working on a medium-term strategy for agriculture, which would include the privatization of state farms.

Mr. Solheim made the following statement:

> Decades of strict central control, improper priorities in the conduct of economic policy, and general neglect have brought the Albanian economy to a state of desolation that is quite unique by European standards. Moreover, the pace at which the economy has unravelled after the breakdown of central control has been unprecedented, even compared with other formerly centrally planned economies. The program presented has to be assessed against this background. In addition, the lack of an adequate statistical base makes policy formulation as well as monitoring of the program particularly difficult.
>
> Positive supply responses of a magnitude sufficient to redress the recent rapid contraction of the economy can be expected only over the medium term. Initially, domestic demand will have to be curtailed through substantial reductions in real wages and tight fiscal and monetary policy.
>
> A near total loss of expenditure control, coupled with a fast erosion of the tax base and a strongly contracting economy, has resulted in an appalling budget deficit, equivalent to almost 50 percent of GDP. Reduction of the deficit to 20 percent of GDP, as envisaged in the program, should be considered an absolute minimum. Current expenditures must initially bear the brunt of the adjustment, but, at the same time, rebuilding the tax base is an area that should be given the highest priority, as it is crucial to attain the further necessary fiscal correction.
>
> Reforms encouraging positive supply responses to the price liberalization should be implemented as quickly as possible. The agricultural sector would seem to warrant special attention in this respect. Furthermore, creation of a viable banking sector will require that the large stock of nonperforming loans be removed from the banks' balance sheets.
>
> The external financing requirement remains uncomfortably large over the medium term. Considerable donor support will be required for some time to come, and the likelihood for prolonged Fund involvement is obvious. At the same time, it is clear that, although the envisaged adjustment is considerable, it

falls far short of what will be needed to correct the prevailing imbalances in the economy. Nonetheless, we are prepared to support the proposed program, accepting the view that at present it represents the maximum obtainable under existing circumstances. We urge the Albanian authorities to adhere strictly to the objectives of the program in order to establish a track record, which eventually could lead to the adoption of an ESAF program.

Mr. Wright made the following statement:

There is no doubt that Albania requires international assistance urgently. I find it hard to recall another country that has come so close to economic collapse. But the Fund, as others have pointed out, faces enormous risks in lending to Albania at this stage. There must be serious doubts about whether this program is strong enough to avert the risk of hyperinflation and whether the authorities have the capacity to implement it.

In these circumstances, a case might have been made for the Fund to concentrate on providing primarily technical assistance to strengthen Albania's institutional capacity before committing Fund resources. Other agencies are better suited to providing Albania with the immediate concessional financial help that it requires.

However, like other speakers, I recognize that the authorities have shown evidence of their commitment to reforming the economy. The list of prior actions already implemented is impressive, and there has already been commendable progress in privatizing small enterprises and agricultural land. It is far from clear that even these impressive efforts match the scale of the problem, but it would be difficult and wrong for the Fund to stand aside and withhold support for Albania's efforts in these circumstances. I agree with Mr. Clark's comments on the risks of the program and the reasons to support it.

The authorities should be under no illusion about the adequacy of the program. A fiscal deficit of 19 percent of GDP financed almost entirely through the banking system, together with negative real interest rates, would be a dangerous combination in any circumstances. At a time when prices and the exchange rate are being liberalized, it is potentially explosive.

In view of these risks, I would strongly encourage the authorities to treat the program's objectives for the second half of 1992 as the absolute minimum that is required. If it can be managed, an even more ambitious pace of macroeconomic stabilization would pay dividends in the longer run. I agree with the comments of earlier speakers concerning areas where strengthening might take place and I will not repeat them.

The World Bank has moved with unprecedented speed to start lending to Albania. For the first time in Eastern Europe, the Bank has actually moved ahead of the Fund. While the Bank's critical imports loan will provide much needed temporary relief, it is essential that the authorities reach early agreement with the Bank on operations to restructure the enterprise and financial sectors. Experience elsewhere in Eastern Europe suggests that, without rapid progress in these sectors, macroeconomic stabilization will prove even more costly in terms of output loss than is necessary.

I am sure that the authorities are right to make reviving the agricultural sector a top priority. This sector can respond rapidly to proper price incentives, and this response makes it all the more important to liberalize the prices of essential foodstuffs and eliminate subsidies. It will also be important to ensure that Albania's agricultural output is given adequate access to Western markets. I would be interested to know from the staff to what extent the agricultural sector is integrated into the tax system.

The staff report refers several times to "spontaneous privatization" and suggests that such actions have contributed to the collapse of output. I would be interested to know exactly what this process involves and whether it could be encouraged without these adverse effects on output. I would be interested to know a little bit more about the prospects of reviving chromium production. Albania used to be the world's third largest producer. I was encouraged, but slightly surprised, that it remains the third largest producer. This sector could offer a unique opportunity for attracting inward investment and earning foreign exchange.

Finally, I am glad to hear that it was possible to make Albania ESAF-eligible earlier this year. I hope that Albania will be able to take advantage of an arrangement under the ESAF or a successor facility. But it could, in my view, be counterproductive to rush into discussions on a three-year program until the authorities are quite sure that they can meet the more demanding conditionality involved. The staff's approach in this case has been the right one.

Mr. Esdar made the following statement:

There is no doubt that Albania, after so many years of almost complete isolation and after the collapse of the old economic system, faces an extremely difficult situation that is even more severe than that faced by other countries in transformation. Therefore, there is no question that Albania needs the support of the international community to overcome its pressing problems. Given the insufficient institutional framework, the limited administrative capacity, and the many uncertainties, the program will encounter severe risks, and it may be difficult to bring this program into line with the general standards and conditionality requirements for Fund programs. However, I agree with Mr. Clark that the program is the best that can be expected under the given circumstances.

While the envisaged reduction in the budget deficit by more than half for the second part of 1992 is commendable, it will still remain at an unsustainable level of 20 percent of GDP. The public deficit cut depends to a large extent on an extraordinary decrease in public spending, including the wage bill. In the past, the Government has experienced severe difficulties controlling public expenditures. To quote the background paper, "Other ministries at present operate virtually out of reach of the Ministry of Finance."

As far as the wage bill is concerned, the wage structure in the public sector needs a complete reform, but, given the difficult social situation, I wonder whether it would be possible or realistic to expect that wage demands can be resisted at a time when prices will be increasing substantially. Therefore, I appreciate the incomes policy as envisaged, and I hope it can be implemented successfully.

The prospects for strengthening the revenue base are also uncertain. Traditional revenue sources have dried up. Given the virtual collapse of industrial production and the obsolescence in state enterprise operations, revenue production now depends, to a large extent, on new sources such as customs duties and excise taxes--areas where administrative capacity did not previously exist and has to be built up from nothing. In this context, I noted that the agricultural sector will be more or less excluded from taxation and assigned the highest priority for promotion. I wonder whether this decision can lead to a lasting solution in the medium term.

Considerable progress has been made in price liberalization, with items covering only about 25 percent of the household consumption basket still under control. However, I wonder how the fact that some wholesale prices for agricultural products remain substantially under world market levels can be reconciled with the importance that is currently given to the rehabilitation of the agricultural sector. In addition, I agree that the establishment of private ownership of land should be given highest priority.

The staff does not conceal the severe risk involved in the program. These risks are aggravated even more by the fact that the financing of the program is not assured. The financing gap for 1992 could not be closed yet, and in 1993, there remain severe gaps. I heard the comments by the staff. However, I cannot fail to note that, while European Community members within the G-24 have agreed to contribute to closing the gap, the response from some non-European Community members of the G-24 is disappointing.

There remain some questions about the magnitude of the Fund's financial involvement in Albania, especially given that ordinary resources are involved. Perhaps the staff could explain in more detail why an access of 80 percent was proposed. The Fund could--and should--play a major role in providing technical assistance and helping the authorities develop a macroeconomic framework. An ESAF arrangement based on an appropriate framework would be certainly helpful, and I encourage the staff to begin negotiations in this direction. However, Albania's financing needs are of a structural nature and would be best covered by those institutions with the mandate to provide long-term financial assistance on a concessional basis. I, therefore, note with some concern the finding in the staff report that Fund involvement in Albania is expected to be prolonged.

In conclusion, the program presented today involves considerable risks and uncertainties. However, if the majority of the Board supports this request, I certainly can also support the proposed decision, especially taking into account the difficult situation in Albania and the determination with which the authorities are pursuing their reform efforts, which is made clear by the implementation of the prior actions.

Mr. Posthumus made the following statement:

I strongly support this program. Indeed, it is the best that can be expected, as Mr. Clark has said. The Fund side of the program is in experienced hands. Albania, with this program, like all the other previously centrally planned economies, is not talking about liberalizing or improving a badly working economic system. It is building a completely new system, which includes completely new uncertainties for the Fund as well.

For most formerly centrally planned economies, one of those uncertainties has been growth estimates. In the Albanian case, I do not know whether staff is allowed to make growth estimates of minus 10 percent, but it seems much more realistic than minus 3 percent in the second half of 1992, and 0 percent to minus 2 percent in 1993, because the country is at the early stage of the reform process.

The interenterprise arrears mentioned by the staff were a phenomenon in which all the shortcomings of the centrally planned system and all the dangers inherent in the reforms to bring about a new system come together. I would appreciate the staff's comments on these arrears, particularly on why they have become so substantial in most other countries in the area, while they have developed much less strongly in Bulgaria.

Price liberalization obviously is an important element of the program. For it to work, a fiscal and an organizational infrastructure is needed. I have noted, like Mr. Wright, that the World Bank, having started its programs, is, in this case, ahead of the Fund. I would have expected the Bank programs to be on a much larger scale in the infrastructural field--both fiscal and organizational--because only then can price liberalization be implemented effectively. However, the situation now existing was one in which the Fund and the Bank could work together.

I have a question for Mr. Filosa about his remark on page 2 of his opening statement that the authorities have decided to adopt a strong shock therapy for economic recovery. We read sometimes in academic papers that a choice must be made between shock therapy and a gradual approach. For Albania, there was no choice. The shock had already occurred with the collapse of the system. The therapy cannot add any additional shock. The staff's advice and the Government's policies were not a shock therapy, but trying to do everything simultaneously and as fast as possible. I hope that these efforts were somewhat systematic. I wonder whether it is even wise to term the Albania program a shock therapy, because such terminology can cause unfavorable political reactions, not by those favoring a gradual strategy, but from circles who want to turn history around, so to say. Perhaps Mr. Filosa could comment.

Mr. Filosa said that the authorities had no alternative to the deficit reduction and wage policies that had been agreed. However, the authorities could not go any further in lowering real wages or applying additional shock therapy measures if they were to maintain a political consensus. He expected that Mr. Posthumus's experience with current and prospective members of his constituency would have shown that authorities accepted a certain amount of shock as necessary. A gradual approach to price liberalization had been considered, but had been rejected because it would not work.

As to military expenditures, the Managing Director had stated explicitly that the Fund's intention was to urge a change in the composition of military expenditures, Mr. Filosa recalled. Directors had commended him for that approach.

He still wondered about the prudence of instituting the rigorous targets contained in the stand-by program, Mr. Filosa remarked. He agreed with Mr. Esdar's and Mr. Clark's concerns about whether the program could be implemented. Albania had not yet experienced the full impact of the adjustment in terms of real wages, interest rate changes, and budget cuts. The extent of the shock to Albania's economy--including a reduction in the deficit from 49 percent of GDP to 19 percent--exceeded that in any other program. Therefore, he did not understand why some speakers were questioning the conditionality standards of the stand-by arrangement. As to the likelihood of achieving program targets, it was useful to bear in mind that the deficit had been cut from 70 percent of GDP two months earlier to 49 percent currently. The staff representative from the European I Department had noted that the program would be reviewed when a medium-term facility was being considered.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/104 (8/7/92) and EBM/92/105 (8/26/92).

4. JORDAN - STAND-BY ARRANGEMENT - REVIEW OF EXTERNAL FINANCING

The Fund decides that the second review on the financing of the program contemplated in paragraph 4(e) of the stand-by arrangement is completed. (EBS/92/130, 8/14/92)

Decision No. 10113-(92/105), adopted
August 21, 1992

5. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

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 February 27, 1993. (EBS/92/134, 8/18/92)

Decision No. 10114-(92/105), adopted
August 21, 1992

6. SPAIN - 1992 INTERIM ARTICLE IV CONSULTATION

The Fund notes the staff report for the 1992 interim Article IV consultation with Spain (SM/92/145) and declares the consultation completed.

Decision No. 10115-(92/105), adopted
August 7, 1992

7. ANNUAL REPORT, 1992 - TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the transmittal of the 1992 Annual Report to the Board of Governors under cover of the letter set forth in EBD/92/36, Supplement 1 (8/5/92).

Adopted August 7, 1992

8. WORLD BANK - RELEASE OF INFORMATION

The Executive Board approves the transmittal of Fund papers entitled "Review of Experience with Programs in Eastern Europe" (SM/92/132) and "Reform Strategy in the Former U.S.S.R." (SM/92/146) to the Executive Directors of the World Bank, as set forth in EBD/92/178 (8/10/92).

Adopted August 17, 1992

9. BALANCE OF PAYMENTS EXPERTS' MEETING - RELEASE OF REPORT

The Executive Board approves the proposal to release the report on the meeting of balance of payments experts to the Fund's balance of payments correspondents, as set forth in SM/92/152 (8/5/92).

Adopted August 13, 1992

10. 1992 ANNUAL MEETING - EXECUTIVE BOARD - REPRESENTATION EXPENSES

The Executive Board approves the recommendation of the Committee on Executive Administrative Matters concerning representation expenses at the time of the 1992 Annual Meeting as set forth in EBAM/92/64 (8/14/92).

Adopted August 21, 1992

11. ADVISORS TO EXECUTIVE DIRECTORS - REMUNERATION

The Executive Board approves the recommendation to increase the remuneration of Advisors to Executive Directors as set forth in EBAM/92/63 (8/14/92).

Adopted August 21, 1992

12. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/10 through 92/17 are approved.

13. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/52, Supplement 1 (8/21/92), EBAM/92/57, Supplement 1 (8/7/92), EBAM/92/58 (8/6/92), EBAM/92/60 (8/7/92), EBAM/92/61 (8/11/92), EBAM/92/65 (8/19/92), and EBAM/92/68 (8/21/92), by Advisors to Executive Directors as set forth in EBAM/92/58 (8/6/92) and EBAM/92/60 (8/7/92), and by Assistants to Executive Directors as set forth in EBAM/92/62 (8/12/92) and EBAM/92/66 (8/19/92) is approved.

APPROVED: March 24, 1993

LEO VAN HOUTVEN
Secretary