

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/82

2:30 p.m., June 29, 1992

M. Camdessus, Chairman

Executive Directors

M. Al-Jasser  
G. K. Arora  
Che P.

T. C. Dawson  
J. de Groote

R. Filosa

I. Fridriksson  
H. Fukui  
B. Goos  
J. E. Ismael  
A. Kafka  
J.-P. Landau  
A. Mirakhor

D. Peretz  
G. A. Posthumus

A. Torres

A. Végh

Alternate Executive Directors

A. A. Al-Tuwaijri

Wei B.

Chen M., Temporary

G. C. Noonan

J. Jamnik, Temporary

M. E. Hansen, Temporary

J. Prader

N. Espenilla, Jr., Temporary

J. Papadakis

A. F. Mohammed

J. A. Solheim

K. Ishikura, Temporary

B. Esdar

T. Sirivedhin

J. C. Jaramillo

P. Bonzom, Temporary

O. Kabbaj

L. J. Mwananshiku

D. A. Bai, Temporary

A. R. Ismael, Temporary

R. Marino

A. Martínez-Aías, Temporary

A. G. Zoccali

J. W. Lang, Acting Secretary

B. R. Burton, Assistant

L. Collier, Assistant

1. Period for Consent to Increases in Quotas Under Ninth  
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### Also Present

IBRD: J. Khalilzadeh-Shirazi, South Asia Regional Office; S. Rahim, Middle East and North Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; P. Dhonte, A. J.-P. Feiler, S. M. Nsouli. Central Asia Department: H. Neiss, Director; D. Goldsbrough, U. Patel, B. R. H. S. Rajcoomar. European I Department: A. A. F. Op de Beke. Exchange and Trade Relations Department: J. T. Boorman, Director; A. Basu, A. R. Boote, S. Kanesa-Thanan, G. R. Kincaid. External Relations Department: R. W. Russell. Fiscal Affairs Department: M. Z. Yucelik. Legal Department: F. Gianviti, General Counsel; H. Elizalde, J. L. Hagan, Jr., R. B. Leckow. Middle Eastern Department: M. A. El-Erian, M. Yaqub. Secretary's Department: A. Leipold, S. W. Tenney. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; E. Decarli, S. I. Fawzi, S. J. Fennell, D. K. Kar, T. Voulgaris. Office of the Managing Director: P. R. Narvekar, Special Advisor to the Managing Director; P. B. A. Andrews, Personal Assistant to the Managing Director. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, M. B. Chatah, L. Dicks-Mireaux, B. R. Fuleihan, M. Galán, M. J. Mojarrad, M. Nakagawa, A. Raza, A. M. Tanase. Assistants to Executive Directors: G. Bindley-Taylor, J. H. Brits, O. A. Himani, J. Jonas, P. K. Kafle, K. Langdon, W. Laux, M. Mrakovcic, L. F. Ochoa, S. Rouai, P. Rubianes, S. Shimizu, N. Sulaiman, R. Thorne.

1. PERIOD FOR CONSENT TO INCREASES IN QUOTAS UNDER NINTH GENERAL REVIEW  
AND SUBSTITUTION OF ORDINARY FOR BORROWED RESOURCES UNDER ENLARGED  
ACCESS POLICY - EXTENSION

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The Executive Directors considered a proposed decision to extend the period for consent under the Ninth Review of Quotas and substitution of ordinary for borrowed resources under the enlarged access policy (EBD/92/128, 6/24/92).

The Chairman said that it would be helpful to receive a status report from Executive Directors whose countries had not yet consented to their quota increases under the Ninth General Review or accepted the Third Amendment.

Mr. Dawson said that that afternoon the U.S. Senate would start debate on the "Freedom Support Act," which contained authorization for the quota and acceptance of the Third Amendment. It was his understanding that the Senate leadership had agreed that there would be a vote on the authorization by the full Senate later that week. The legislation likely would be passed.

The House Banking Committee had included in the legislation to go to the floor of the House of Representatives both the authorization and the appropriation, Mr. Dawson noted. After the House had considered the matter, there would be a joint conference between the House and the Senate to allow the quota legislation and acceptance of the Third Amendment to go forward.

Consideration by the House of Representatives, however, was not expected prior to the Democratic National Convention in July 1992, Mr. Dawson indicated. He was hopeful that the House would take action sometime between the Democratic Convention in July and the Republican Convention in August. Action by the House might be postponed until the Congress reconvened in September, after the Republican Convention. He expected that the House and Senate would remain in session for the full month of September, because of the manner in which the U.S. fiscal year worked.

Although he had hoped for a more rapid passage of the legislation, he was optimistic about its chances, Mr. Dawson commented. The inclusion of the appropriations language by the House Banking Committee was particularly encouraging. The proposed decision now before the Board to extend the period of consent to September 30, 1992 was appropriate. In particular, he supported the proposal in the staff paper that the Board convene to discuss the matter of the consent to the quota increase and acceptance of the Third Amendment in September in anticipation of the Interim Committee meeting. Notwithstanding the fact that U.S. passage of the legislation was still pending, it was his view that the progress that the United States had made in the past two months was probably better than expected. There was now a bipartisan willingness to push the matter forward, despite its being an election year.

Mr. Filosa remarked that the new Italian Government had renewed the decree effecting the quota increase. However, government approval, followed by parliamentary action, was needed to accept the Third Amendment. He hoped that a streamlined parliamentary procedure would be introduced to obtain Parliament's consent to the quota increase and acceptance of the Third Amendment before the proposed extension now before the Board expired. He stressed that the delay was due only to parliamentary procedure. There was no opposition whatsoever to the content of the Third Amendment itself. The Board's agreement to the postponement of the deadline for the consent to the quota increase and the acceptance of the Third Amendment was, therefore, important in order for the Italian Government to participate. He was optimistic that Parliament would be able to act by the date of the proposed deadline.

Mr. Fukui commented that it was regrettable that the deadline had to be postponed again. However, because the three-month extension was relatively short, and the next two to three months constituted a sensitive period for U.S. Congressional discussions, he supported the proposed extension. At the same time, he asked Mr. Dawson to keep the Board abreast of the situation as it developed in Congress, given the importance of the U.S. quota. He would not speculate on the likely outcome, but he hoped that Mr. Dawson's optimism was well founded. If the quota increase was unfortunately delayed beyond the end-September extension, management would need to propose an effective way out of a difficult situation, including the delinking of the quota increase from the Third Amendment. With great concern, he supported the proposed decision.

Mr. Posthumus said that he, too, supported the proposed decision.

Mr. Goos stated that he wondered whether Mr. Dawson could elaborate on why it was not possible to bring the legislation to the House before the Democratic Convention. He wondered whether there was any technical reason for the timing, or whether putting more pressure on Congress might lead to earlier passage of the legislation by both houses.

As to the proposed decision, he supported the thrust of the text, but he was not sure what was meant in section 1, subsection 3, where it said that "early ratification of the general increase in members' quotas under the Ninth Review is imperative given the increasingly important role of the Fund in the world economy." He wondered whether it was intended to mean that the Fund should step up its surveillance over industrial countries' economic policies. He did not see a fundamental change in the importance of the role of the Fund in the world economy. If that subsection referred to the heavier demands on the existing resources of the Fund, then it should be rephrased to say that.

Mr. Al-Jasser commented that if the words "given the increasingly important role of the Fund in the world economy" referred to the Fund's expanded geographic role, with its 26 new members, rather than to the Fund's importance in the world economy, he would support the original wording.

However, since its inception, the Fund had been an important participant in the world economy, and the impression should not be given that the Fund would become more important because of the Ninth Review.

The Chairman proposed that the words "given the increasingly important role of the Fund in the world economy" be deleted.

The Executive Directors accepted the Chairman's proposal.

Mr. Dawson, responding to Mr. Goos's question about the possibility of earlier action by the U.S. Congress, commented that the Democratic leadership in the House of Representatives in particular should be given credit for adding the appropriation to the authorization bill two weeks ago. They had been motivated by a spirit of cooperation and a sense of the important role of the Fund in the world economy. That single act had signaled that there was broad support for the legislation. The delay in the vote until after the Democratic Convention was tactical--a question of the right time to put a vote that was difficult for many members to the House floor, because of public concern that foreign policy had been given priority over domestic needs. By postponing the vote until after the Democratic Convention, the House leadership was improving the chances for a favorable vote.

Mr. Goos replied that he had understood that the main stumbling block for the Democrats in supporting the pending legislation had been that, in their view, the Administration had not appeared to be fully behind the quota increase. They had asked in particular for President Bush to declare his support publicly. He wondered whether there was still any doubt among the Democrats about the Administration's--particularly President Bush's--position. Perhaps those doubts explained why the Democrats preferred to wait until after the Democratic Convention before bringing the legislation to a vote in the House of Representatives.

Mr. Dawson stated that it was his assessment that the delay in the vote was not due to the Democrats' concern about the Administration's support; the House Banking Committee had approved the legislation by a 2 to 1 margin involving both Republicans and Democrats. At the mark-up of the legislation, no Committee members had indicated that they needed a further demonstration of the President's support for the legislation. There was, however, a letter signed by approximately 100 Democratic Congressmen that stated that the United States should not give aid to the former Soviet republics; instead, the focus should be strictly on domestic issues. Therefore, the Congressional leadership had made a tactical decision to wait until the hiatus between the two parties' conventions, when partisan passions would be somewhat cooler.

The Executive Board approved the following decision.

1. The Executive Board, considering that:
  - it is a matter of great regret that some member countries have not yet consented to the quota increase under the Ninth Review or accepted the Third Amendment;
  - it appears that both the quota increase and the Third Amendment will not become effective before the end of June 1992;
  - early ratification of the general increase in members' quotas under the Ninth Review is imperative;
  - the Fund's liquidity position is projected to decline rapidly during 1992-93, which increases the urgency of the quota increase coming into effect as early as possible,

urges those members that have not yet consented to their quota increases under the Ninth Review or accepted the Third Amendment to make every effort to complete the necessary procedures as soon as possible.

2. The Executive Board has reviewed Decision No. 9546-(90/145) on the substitution of extraordinary for borrowed resources in financing purchases made under arrangements approved under the Policy on Enlarged Access, and decides that that decision shall continue to apply to arrangements approved not later than the date on which the requirement for the effectiveness of increases in quotas under the Ninth General Review of Quotas specified in paragraph 3 of the Resolution of the Board of Governors No. 45-2 has been fulfilled, or September 30, 1992, whichever is earlier.

3. Pursuant to paragraph 4 of the Resolution of the Board of Governors No. 45-2, "Increases in Quotas of Members - Ninth General Review," the Executive Board decides that notices in accordance with paragraph 2 of that Resolution must be received in the Fund before 6:00 p.m., Washington time, on September 30, 1992.

4. The Executive Board will review the status of the quota increase and the Third Amendment not later than September 11, 1992 and examine the steps that could be submitted for consideration by the Interim Committee if the necessary procedures have not been completed by that date.

Decision No. 10062-(92/82), adopted  
June 29, 1992

2. INDIA - REVIEW UNDER STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on the review under the 20-month stand-by arrangement for India approved on November 5, 1991 (EBS/92/96, 6/3/92; and Cor. 1, 6/24/92).

The Director of the Central Asia Department said that, at a meeting of the India consortium in Paris the previous week, strong donor support for India's current economic policy direction had been translated into larger new aid commitments. The authorities had originally sought total commitments of \$6.7 billion--the same amount that had been pledged in 1991 under crisis conditions. However, in the event, total commitments in 1992 now amounted to \$7.2 billion, which was an increase in both nominal and real terms. That result could be considered good, given the increased global demand for aid. A substantial amount of the aid committed--\$1.8 billion--was in the form of fast-disbursing loans. If prospective Fund drawings under the \$1.6 billion stand-by arrangement were included, total fast-disbursing funds available in 1992/93 would be \$3.4 billion, which should easily cover the expected gap in exceptional aid.

Investigations into the financial scandal that had been discovered by the Reserve Bank of India late in April 1992 were still continuing, the Director stated. The investigations had revealed a collusion between some brokers and officials of some commercial banks, which included, among others, the State Bank of India, the largest national banks, and two or three foreign banks. Those two sets of officials had siphoned off funds illegally from the banking system and channeled them into the stock market. The amount outstanding was currently estimated to exceed \$1 billion dollars. After the recent stock market decline, that amount would be difficult to recover. Although the amount was large--almost half of one percent of GDP--the loss would not derail macroeconomic policies, but it would make the needed recapitalization of state banks even more difficult. At the same time, it was hoped it would help accelerate financial sector reform.

The 15 percent tax on foreign travel--a restriction temporarily approved at the previous Board discussion on India (EBM/91/145, 10/31/91)--had been abolished, the Director indicated. That measure and the liberalization of gold imports meant that the scope of the black market in foreign exchange had been greatly reduced. In fact, the black market rate had moved close to the official rate in the free market.

Finally, the climate for direct investment had improved, the Director of the Central Asia Department commented. The requirement that profit transfers be linked to export earnings had been abolished. That particular requirement had been the cause of some concern to prospective investors.

Mr. Arora made the following statement:

My authorities endorse the principal conclusions of the staff paper for the first review under the stand-by arrangement for India. It should be recalled that around this time in 1991, the economic situation in India looked grim, indeed. India was faced with the risk of external default. Our foreign exchange reserves had dwindled to insignificant levels. There was the specter of economic instability with high inflation. Stabilization policies, put into motion in the winter of 1990/91, had faltered because of political instability. Restoration of macroeconomic stability was taken in hand immediately after the new Government took office, after a parliamentary election that was concluded in mid-June 1991.

The results speak for themselves. How did this truly dramatic change come about? Two factors need to be highlighted: first, a strong and courageous policy response centering on exchange rate adjustment, interest rate and monetary policy, and significant fiscal correction. Simultaneously, industrial deregulation and trade liberalization policies were announced, with a view to assigning to market forces a pivotal role in a changing domestic and international environment. Second, the cooperation and support given by the international community at a critical juncture in our history was crucial in restoring confidence.

Today we see the encouraging buildup of international reserves, a gradual reduction in inflation, the continuation of structural reform, and quickening interest in India by foreign investors. The immediate crisis having been overcome, it is time to take stock of what has happened during the first year of the program and to consider the agenda for future action in 1992/93.

During 1991/92 the fiscal correction remained broadly on track. The deficit fell sharply from 8.7 percent of GDP in 1991 to 6.5 percent. There was a minor underperformance under the fiscal program, for which a waiver has been requested. The increase in revenues was less than programmed, largely on account of massive import curtailment. Accordingly, the adjustment burden was borne largely by sharp cuts in expenditure.

The turnaround in the external position is due primarily to a fairly crippling reduction in imports and a resumption of capital flows in response to policy changes that restored international confidence in the prospects of the Indian economy. It should be mentioned that the turnaround is noteworthy, occurring as it did against a background of markedly lower exports to the former Soviet republics.



The picture on the inflation front was, however, not so encouraging, as the decline in inflation was gradual, owing to supply-side constraints predominantly in agriculture where a less than satisfactory monsoon depressed output. In India it is often the case that inflation is driven largely by food prices. It has also to be admitted that the stance of monetary policy was not sufficiently tight inasmuch as broad money rose by 18.5 percent in 1991/92--well above the target of 13 percent. There was a silver lining to the monetary cloud. Much of the monetary expansion was based on a larger than anticipated rise in foreign exchange reserves.

Policies for structural reform were implemented energetically. There have been some slippages, as the staff points out; nevertheless, what is important is that the intellectual groundwork for more rapid and sustained change has been completed. It is no exaggeration when I say that in India today the debate is not about the direction of change; it is largely about the speed and sequence which are, of course, legitimate subjects for inquiry and dissent.

The economic strategy and policy objectives for 1992/93 derive from the overall 1991/92 performance. Fiscal consolidation continues to be the centerpiece of the program. A reduction in the fiscal deficit from 6.5 percent of GDP in 1991/92 to 5 percent in the current fiscal year is planned. The adjustment will take place largely on the expenditure side once again. Further reduction in subsidies by approximately 1/2 of 1 percent of GDP constitutes a major step toward a structural reform of the budget. Spending on defence in real terms will continue to show a downward trend. Measures are being taken to bring about a greater degree of discipline in the fiscal operations of the states.

Monetary policy for 1992/93 will be targeted at curbing broad money growth in a somewhat drastic manner. The important thing to notice is that the restricted stance of monetary policy will not be allowed to come in the way of the expansion of much-needed credit to the commercial sector.

External sector policy would aim at stimulating the recovery of imports from vastly depressed levels and at increasing export volume by 4 1/2 percent, notwithstanding the continuing decline in exports to the CIS markets. A small buildup of reserves is planned. An overall financing gap of about \$3 billion is projected--a gap smaller than originally programmed. Financing arrangements to fill the gap do not appear to present major difficulties. Looking to the medium term, we expect financing needs to decrease substantially beyond 1992/93 and to be eliminated altogether by 1996/97.

A major change in the exchange rate system has taken place with effect from March 1992. An explicit dual exchange rate system with a market-determined rate for most current and capital account transactions and a more appreciated official rate for key imports is now in place. In the first nearly four months of operation, the spread between the two rates has averaged about 18 percent, and the authorities intend to keep the spread within a maximum of 20 percent. Our policy intention is to unify the rate within two to three years. However, if economic circumstances are favorable, the transition to full convertibility could come about within a much-shortened time frame.

Significant progress in structural reform continues to be made. A substantial liberalization of the trade system with a virtual dismantling of the system of quantitative restrictions has marked India's movement toward closer integration with the world economy. Concurrently, the first phase of a major tariff reform has been completed. Maximum tariff rates have been lowered, while specific duties on capital goods have been reduced fairly sharply. Over the next two to three years, we plan to reduce tariff levels to levels prevailing in most developing countries.

The Government is working on a comprehensive tax reform program. In the budget of 1992/93, personal income taxation was streamlined. A similar restructuring of corporate taxation will be attempted in the next phase.

Significant action on public enterprise reform, including divestment, has been initiated. We anticipate that, over the next two to three years, public sector industry will be rationalized and restructured, subjecting it to greater market discipline. Such restructuring will, of necessity, involve the closure of unviable units. To help an orderly restructuring process, the Government has established the National Renewal Fund, which will provide for compensation, retraining, and relocation of workers who will lose jobs.

In the financial sector, the budget has already taken some important steps forward. The statutory liquidity ratio has been lowered; the move toward market-determined rates, including on government securities, has been intensified; regulatory and supervisory policies and programs are being strengthened; and doors have been opened for the entry of private sector banks. We still need to address issues of capital adequacy and greater transparency and market-based operational policies. I would like to assure the Board that the recent problems confronting some segments of the Indian banking system will not be allowed to

impede reforms in the financial sector. If anything, the recent troubles have only strengthened the resolve of the Government to place India's financial institutions on a sound and competitive basis.

The central objective of the 1992/93 program is to bring about a sharp reduction in the inflation rate in order to create an appropriate framework for resumption of sustained economic growth. The strategy rests largely on tighter national policies, although supply-side improvements coming from structural policy reform will undoubtedly play a major role in promoting noninflationary growth over the medium term.

I should be grateful for the Board's approval of the review and of the program for 1992/93. It goes without saying that the support provided by the Fund has been a major contributory factor in India's current effort to reshape its economic system. We recognize that success in liberalizing our economy will depend most crucially on what we ourselves bring to this important task. However, multilateral and bilateral cooperation would continue to be an important dimension of our own endeavor to put things right.

A year of turbulence and crisis management is behind us. We are now moving into the next phase of consolidating our gains to create conditions for resumption of growth and development. We look to the Board for suggestions and advice to help us in our arduous task.

Mr. de Groote made the following statement:

The Indian economy is now in a much better position than it was a year ago. However, this improvement is mainly because the situation in 1991 was nearly catastrophic. Despite the progress made in addressing the most urgent problems, the authorities now have little reason to pause and celebrate. There is no disputing the vigor of their efforts to change fundamentally the Indian economy, but the reality is that, due to the burdensome legacy of decades of economic mismanagement and unfavorable external circumstances, most of the difficult task of transforming the Indian economy into an efficient market system still lies ahead.

Deep structural changes, supported by proper macroeconomic policies, will be required to bring the economy onto a growth path that will provide an increasing real per capita income and suppress inflation. Regrettably, neither the structural change nor the appropriate policies are yet sufficiently advanced.

To be sure, India has taken a significant step toward opening its economy to foreign investors and foreign competition, as

evidenced by the list of structural benchmarks already met. At the same time, however, little has been done to dismantle the archaic system of numerous preferences, subsidies, and other relics of the past. To give an example from recently published surveys on India, not much progress has yet been made on increasing the flexibility of the labor market. In addition, labor interests are opposed to capital investments in such important areas as the banking sector.

This position is unfortunate not only because it delays a necessary reallocation of labor, but also because it has further aggravated the problems in the banking sector. In the past, the banks played the de facto role of fiscal agent for the state by allocating resources to selected industries on preferential terms, resulting in an accumulation of bad loans, just as in many countries of Central and Eastern Europe. But if the vested interests of labor continue to obstruct greater labor flexibility and an increased capital to labor ratio in the banking industry, there is little hope that the inflow of private capital will help solve the problem of bad loans on the balance sheets of the banks. In the end, a fiscal solution to the problem with all the undesirable consequences that the authorities are trying to avoid may be necessary.

I am less concerned than the staff about inflation. True, an inflation rate around 13 percent is certainly not sustainable in the long run, and I fully agree that it would be desirable to reduce it to a single-digit level. But in countries undergoing significant structural and macroeconomic changes, it seldom happens that inflation declines during the process: the opposite is more often true. What is more important is whether the fiscal and monetary policies offer a prospect of low inflation in the longer period. In this connection, some concerns are warranted, especially on the fiscal side.

I noted with satisfaction the decline of the overall fiscal deficit. Unfortunately, the greatest share of this decline was achieved at the cost of reduced capital expenditures. Though some subsidies were also cut, subsidies remain uncomfortably high and create costly distortions. And although the reduction of some ineffective public investment can be justified, cutting capital expenditures can also threaten the prospects for future growth. This risk is further magnified by the major import compression that occurred in the course of 1991 as a result of efforts by the authorities to address the balance of payments crisis. Consequently, the declining trend in the investment to GDP ratio should be a matter of concern.

It must be acknowledged that the only basis for future growth is a dynamic private sector. The private sector is, however, in a

difficult position, due, among other reasons, to the discriminatory character of bank lending. Unless the efficient private industry sector is relieved of the burden of providing subsidies to the inefficient agriculture and government sectors, the prospects for India to improve its economic performance will remain dim. To ensure more equal treatment of the growing private sector, an adequate solution for the problem of bad loans will have to be found. Otherwise, credit policy will only serve, explicitly or implicitly, to channel cross-subsidies from the more efficient to the less efficient sectors.

Concerning the staff's language, on page 3 of the staff report, referring to the decline in inflation from 17 to 13 percent--which is to say by approximately 25 percent--the staff mentions "its persistence." On the same page, referring to a reduction of the fiscal deficit from 8.7 percent to 6.4 percent of GDP--also about 25 percent--the staff says that it "fell sharply." In order to achieve symmetry of language in evaluating fiscal and monetary performance, should the staff not describe the inflation performance as "sharp persistence?"

The Indian authorities have demonstrated during the past year a willingness to address the serious problems that the economy has inherited from the past. There is evidence that this effort is beginning to bear fruit, and we strongly encourage the authorities to continue it. We can support the request for waivers.

Mr. Peretz made the following statement:

I welcome the impressive progress made by the Indian authorities in restructuring the economy since this program was approved in October 1991 (EBM/91/145, 10/31/92). They are now implementing economic reforms that mark a clear break with policies of the past.

As the staff assessment points out, the immediate external crisis has been overcome, and the program has achieved its first objective of restoring confidence and rebuilding reserves. India has maintained its unblemished debt repayment record, and this practice will continue to benefit the economy greatly. As the reform program continues, the Indian authorities will be able to look to the international capital markets and to foreign investors for external financing. India's medium-term growth prospects will have been correspondingly enhanced.

The apparent political consensus that has developed in favor of reform in India is encouraging. It is also welcome that announcement of policies has generally been matched by speedy implementation. As far back as December 1990, the Indian

Government committed itself to reducing the Union Government budget deficit to 6.5 percent in 1991/92. This target has been achieved. I would stress the importance of building on this success, and achieving the 1992/93 target of 5 percent. This effort is likely to require revenue-enhancing measures such as widening the tax base and tightening collection mechanisms, as well as cutting spending on fertilizer subsidies and outlays to loss-making enterprises, the civil service, and defense. The authorities have been relatively slow to develop comprehensive programs for action in some of these areas.

Moreover, I am concerned that too much of the fiscal adjustment is currently coming from the Union Government. While I recognize the difficulty of controlling the fiscal behavior of the states, their behavior cannot be ignored, and I would urge the authorities to continue to do all they can to bring fiscal restraint to the whole public sector. The constraints imposed on states' access to preferred credit are a move in the right direction, but the staff are right to say that further measures will be needed.

In my view, the authorities will also need to tighten monetary policy, so that further downward pressure is placed on the rate of inflation. The persistence of inflation and broad money growth significantly above the level envisaged in the program puts at risk the progress that has been achieved so far. I would encourage the authorities to develop more effective instruments of monetary policy through further liberalization of interest rates, as well as to take appropriate steps to absorb excess liquidity and to sterilize capital inflows.

The structural reforms implemented so far represent an impressive start; most of the benchmarks for the first review were observed. However, I would stress the need for the implementation of the exit policy for public enterprises and encourage the authorities to press ahead urgently with reform of the financial sector. There continues to be a need to strengthen prudential supervision of the banking system, particularly off-site inspections and the banks' returns system. Tighter regulation of the capital markets is also required, and priority sector lending and preferred credits should be eliminated. While it is understandable that the Indian authorities wish to clean up the commercial banks' balance sheets before privatization, I continue to hope that privatization of the banks will eventually return to the political agenda.

I can support the request for waivers of the performance criteria for the overall borrowing of the Union Government for March 1992 and the introduction of a multiple currency practice. However, I note that the retention of the multiple currency

practice will be reconsidered at the time of the next Article IV consultation. Prudent fiscal and monetary policy should now be aimed at bringing down inflation and permitting the authorities to stabilize the nominal exchange rate. This accomplishment should, in turn, assist the authorities' efforts to abolish the dual exchange rate system. I hope that it will be possible to accomplish these goals on a considerably more ambitious timetable than is currently envisaged.

To summarize, the support for India provided by this institution has been--and continues to be--an example of the Fund working at its best. India required prompt technical and financial support from the international community to meet a temporary liquidity problem. This support underpinned the determined efforts of the authorities, who showed themselves ready to take the measures required to correct the imbalances that had built up in the economy. As a result, India has been able to continue to meet its international obligations in full, thereby maintaining creditworthiness for the future.

It is important that the international community should continue to support India's reform program. Some of this external finance will need to be on concessional terms if an excessive rise in the debt stock is to be avoided. For this reason, while I fully support the present arrangement, I would encourage the Indian authorities to adopt the necessary measures to support an extended arrangement with a concessional element. In this connection, I have already indicated that I am willing to consider an arrangement incorporating access to ESAF resources of up to 50 percent of quota if the strength of the program warrants it.

Mr. Fukui made the following statement:

India has managed to extract itself from the critical balance of payments situation that it experienced in 1991. The authorities' stabilization measures and substantial financial support from the international community led to the earlier and greater than expected strengthening of the external position. This progress is welcome.

At the same time, I would like to emphasize that the Indian authorities should not relax their policy stance toward economic stabilization nor postpone the implementation of the structural adjustment menu. Looking at the performance so far under the current arrangement, I am concerned about the still high level of inflation, which was not reduced as planned. Also worrisome is the delay in formulating a plan for tax reform and removing barriers to the closure of unviable firms--the two measures that together constitute the most important part of the structural

reform. All those concerns call for the authorities' uninterrupted efforts during the coming period. I basically endorse the staff's recommendations on specific policies.

Fiscal strengthening is one of the most pressing issues to be tackled. In view of the low ratio of revenue to GDP in India, a comprehensive tax reform to broaden and strengthen the revenue base is the authorities' most urgent task. A detailed plan and timetable for this reform should be established without delay.

On the expenditure side, I would like to note two points. First, although the program envisages wide-ranging expenditure control, I cannot help having doubts about whether fiscal control over the state governments can be effectively conducted. Because the states have been given a substantial mandate for fiscal management, fiscal consolidation in the state governments is planned to be achieved indirectly, only through a hardening of budget constraints. In order for fiscal consolidation to have a sustainable, long-term effect at the central government level, it is essential to strengthen the budgetary systems and monitoring procedures of the state governments. As long as the program sets indicative targets for bank credit to the Central Government only, fiscal performance in the states should be kept under careful watch.

Second, while I welcome the decrease in defense spending, more emphasis should be put on current expenditure cuts. I am somewhat concerned that investment and maintenance expenditures might be unduly reduced under across-the-board expenditure restraint. In particular, India has many ongoing development projects. Therefore, due attention should be paid to avoiding shortfalls in local cost financing for those projects. My authorities are interested in this matter, because the local cost of financing affects projects involving Japanese financial institutions.

On the monetary front, it is imperative that positive real interest rates be achieved to make resource allocation more efficient. For this purpose, it does not seem sufficient only, to maintain the ceiling on deposit interest rates above the current 12-month inflation rate. The various kinds of preferred credits that remain should be further reduced and streamlined. While the authorities may not be able to eliminate these credits immediately, they should be altered, so that they are focused more on sectors such as agriculture, small-scale enterprises, and export industries and on purposes such as promoting exports and strengthening competitiveness.

With respect to structural reform, much progress can be seen in many areas. Inter alia, I welcome the progress in industrial



deregulation. This reform is significant, as it not only increases the inflow of nondebt-creating resources, but also brings the attendant advantages of technology transfer and marketing expertise. I expect further deregulation and liberalization on this front--in particular, a further raising of the foreign equity ownership ratio, with automatic approval built in.

As a next step in trade liberalization, it would be appropriate to aim at phasing out the quantitative restrictions on consumer goods imports. This said, I would like to caution the authorities against allowing a critical situation on the external front like that in 1991 to develop again. Import liberalization should proceed further, hand in hand with effective export promotion measures, and a strict stance should be kept on nonconcessional borrowing.

After finding a way out of the balance of payments crisis, India is now entering a most important stage in its economic reform. The financing requirements remaining in the medium term are evidence of the need for the authorities to continue their adjustment effort, supported by the assistance expected from the international community. I welcome the information that the envisaged financial gap in 1992/93 was almost covered by the pledges at the aid group meeting last week. At this meeting, the Japanese Government indicated it would provide concessional loans of about \$860 million, including \$250 million in a fast-disbursing loan. I hope that the international community will also continue to support India and that the Fund will play an important catalytic role in this context.

In view of the fact that India's structural adjustments undoubtedly need to be pursued with a medium-term perspective, I would encourage the authorities to establish a medium-term program with a concrete timetable. However, it is essential, for the moment, that the authorities undertake further economic stabilization measures and make more progress in structural reform under this stand-by arrangement. With these remarks, I fully support the proposed decision.

Mr. Dawson made the following statement:

We agree with the staff appraisal that, under the present stand-by arrangement, India has achieved its immediate objectives of restoring confidence and rebuilding reserves. The turnaround has been dramatic. A year ago reserves were on the brink of exhaustion, and India was on the verge of default. Today, foreign currency reserves are over \$5 billion, and India's creditworthiness is being restored. Equally important for India's long-run economic health, a good start has been made on economic reforms

that hold out the prospect of invigorating the supply side of the economy.

Stabilization is only the first stage in the economic reorientation the Indian authorities are attempting. Comprehensive reforms and continuing adjustment will be needed if the full potential of this reorientation is to be achieved. The scope of this effort is conveyed in Table 6 where structural benchmarks for the second review are listed in six areas: public enterprise reform and industrial restructuring, fiscal policies, financial sector reform, trade liberalization, the exchange system, and foreign direct investment.

We commend the authorities for what they have achieved to date and we fully support their policy orientation and the agenda of reforms that has been sketched out. Nevertheless, this first review of the stand-by arrangement leaves us a little uneasy. Import and investment compression has dominated stabilization efforts over the past year. Longer-term adjustment is less in evidence.

The reduction in the overall fiscal deficit in 1991 from 8.7 percent of GDP to 6.5 percent was an important macroeconomic achievement. The burden of adjustment, however, fell most heavily on capital spending. Revenue growth was weak--highlighting the unhealthy dependence of the Central Government on customs receipts and reinforcing the urgency of pushing forward with revenue reforms. Tax reforms are contemplated, but they need to be pursued more vigorously than currently indicated. Subsidies are a chronic problem in India's budget, and it is disappointing that in 1991, when so much adjustment was required, subsidies overran their budgeted levels.

Further budgetary adjustment is programmed for the current fiscal year, including decreases in subsidies. The staff indicates that meeting these objectives will require additional actions on food and fertilizer subsidies by the end of September 1992. We believe it is important that these specific targets be met. Beyond these actions, however, there are still important areas of spending misallocations that need to be corrected, such as subventions to inefficient state enterprises, losses at state-owned banks, and an excessive government wage bill.

As to monetary policy, it is disappointing that inflation went higher and then declined by less than anticipated under the initial program. This result is particularly troublesome, because the staff states on page 3 of the staff paper that, for much of fiscal 1991/92, financial policies "were not sufficiently tight." The inadequacy of monetary control shows through in the figures for broad money. Instead of broad money growth decelerating from

15 percent to 13 percent, as called for in the original program, it actually accelerated to 18.5 percent. Unsterilized reserve accumulation was part of the problem, but credit to the government sector was also above target. If the broad objectives of India's reform efforts are to be achieved, monetary policy needs to be implemented in a way that both contains monetary growth on a disinflationary path and at the same time improves the flow of credit to the private sector. Proposed financial reforms are movements in the right direction, but they are still too tentative.

On the external front, trade liberalization is an area where clear progress is being made, particularly in the reduction of quantitative restrictions. We look forward to follow-on steps to reduce tariff levels, as called for under announced policies. Steps have also been taken to liberalize the direct investment regime. These measures are welcome, but more needs to be done to improve the climate for foreign investment in India. The projections for 1992/93 still anticipate net inflows of direct and portfolio investment of only \$467 billion--a tiny amount for a country of the size and potential of India--and a country with a prospective current account gap of \$6 billion and net aid disbursements of almost \$2 billion.

The staff discussion of trade and payments results for the past year presents a mixed picture. Most of the net payments improvement seems to have been traceable to administrative controls on imports rather than macroeconomic and exchange rate policies. Reversal of these unsustainable one-time measures is expected to add \$3 billion to the 1992/93 current account deficit. Exports in 1991 suffered from curtailment of trade with the former Soviet Union, but showed some significant gains elsewhere. The staff seems to believe these gains portend a strong secular improvement in India's export performance, because for the next few years they project annual growth in exports of about 13 percent, while import growth would be held in check. We would be interested in a little further staff discussion of India's medium-term trade prospects.

In light of the progress that has been made under the India stand-by arrangement, we are prepared to support today's decisions, including approval of the various waivers necessary for completion of the first review under the stand-by arrangement. Looking forward, we would encourage the Indian authorities to redouble their efforts to implement fully the broad range of structural adjustment policies they have initiated so the full potential of the economy can be achieved.

Mr. Jamnik made the following statement:

The authorities have made a promising start in taking action to stabilize the economy and address the more fundamental causes of India's balance of payments difficulties. Indeed, the external situation has improved more than expected since the 1991 liquidity crisis, with reserves having gone from the equivalent of less than one month of imports to over three and a half months. As we are in agreement with the broad thrust of the staff paper and are confident that the authorities are proceeding in the right direction with their reform program, we can support the draft decision. I will limit myself to a few points of emphasis and one question that the staff or Mr. Arora may wish to address.

India must achieve price stabilization to build and maintain popular support for the reform program. Central bank financing of government deficits has led to chronic inflation problems, and although the Government has undertaken some actions to reduce subsidies and increase revenues, these actions must be expanded upon. Initiatives to privatize public enterprises should progress at a quicker pace, as should efforts to reduce the fiscal burden of the civil service. We would encourage the Government not only to speed up progress on restructuring public enterprises, but also to be vigilant concerning the costs associated with the civil service.

The move from an economy where the state provides so much employment to one where the private sector is to be the driving force cannot be effected without a surge of unemployment; some Indian economists are projecting an additional 11 million unemployed. As the authorities themselves have noted, a credible exit policy with an attendant social safety net will be necessary to avoid social disorder. The National Renewal Fund, to be financed by a \$500 million World Bank loan, is to provide severance pay and retraining for those affected. However, delays in the formulation of policies are impeding the restructuring and labor adjustment process. We would encourage the Indian authorities to make every effort to ensure that the National Renewal Fund is in operation at the earliest possible date.

Clearly, financial markets must be able to attract foreign capital. This is an essential aspect of India's new growth strategy. Important benchmarks concerning financial sector reform are included for the second review. Particular attention needs to be paid to reform of the financial sector, and I would recommend that further measures be taken to move toward a market-based allocation of credit. Toward this end, the number of sectors receiving interest rate subsidies should be further limited, and the movement to market-based interest rates for government securities should be broadened.

In his opening remarks, the Director of the Central Asia Department referred to the recent financial scandal in India. We welcome the assurances that it will not be necessary to re-examine the monetary and fiscal framework of the program in the light of this scandal. I was wondering, however, what measures the authorities intend to take to resolve the problem and to prevent a recurrence. The soundness of the banking system obviously could be improved through a strengthening of banking supervision and prudential regulations. Is such strengthening being contemplated?

In conclusion, there is little doubt that the Government continues to be faced with a daunting task. The success of the adjustment effort will entail unwavering determination on the part of the authorities in their pursuit of tight fiscal and monetary policies, supplemented by appropriate and timely structural reform measures. In light of the projected continuation of financing gaps during the next few years and the need to ensure adequate external financing, we cannot overemphasize the need for continued close monitoring of the situation to ensure that slippages do not develop. If they do, we trust that the authorities will move quickly to offset them through decisive corrective action.

Mr. Landau made the following statement:

Last October, this chair expressed its deep appreciation for the determination and consistency with which India has embarked on a new path of adjustment and economic recovery. Since then, India has made important progress and has been rewarded with impressive results. As underlined by Mr. Arora in his opening statement, a dramatic recovery has taken place in the external sector, characterized by the buildup of foreign reserves and many signs of the return of investor confidence.

Being in broad agreement with the staff, I would like to focus my intervention on the following points: one cannot but be impressed by the magnitude of the adjustment process decided upon for the 1991/92 fiscal year, which allowed the Union Government's overall deficit to drop by 2.5 percent of GDP to 6.5 percent of GDP. The 1992/93 program correctly puts the main bulk of adjustment on further fiscal consolidation, a large part of which is targeted on expenditures. During the previous fiscal year, there was a notable reduction in capital outlays. They are again budgeted to decline by nearly 0.5 percent of GDP in the current fiscal year. Reductions in lending to public enterprises are surely appropriate, but large cuts in investment projects, notably in the health and education sectors, may not be sustainable in the medium term.

I share the staff's view that emphasis should be put on further current expenditure restraint. After the overrun in subsidies in 1991, a better targeting of food subsidies and a phasing out of fertilizer subsidies are certainly welcome measures. Containment in public sector employment and remuneration will also prove essential in the coming years to limit the rise in current expenditures.

Effective control of public expenditures at the state level is the key to ensuring that restrictive actions taken in the Union budget are not offset, but supported, by state budgets. Recent initiatives to better control the budgetary policies of the states certainly constitute a first step.

Of crucial importance will be the progress made in tax reform. Some streamlining of personal income taxation has already occurred. These preliminary actions should be completed as soon as possible by the formulation of detailed measures on corporate tax reform and indirect taxation. These reform measures are a welcome structural benchmark for the second review.

Inflation performance has been somewhat disappointing; therefore, the program rightly provides for a sharp deceleration in broad money growth and a substantial decline in new bank credit to the Government. We support the authorities' intention to tighten monetary policy further in case of renewed inflationary pressures and tensions on the exchange rate.

Interest rate developments are another important factor. Measures have already been taken in terms of liberalizing and raising rates. Continued decisive actions in this field, particularly dismantling the implicit interest rate subsidies on preferred credits, may not only help in the fight against inflation and improve the allocation of resources, but also constitute a clear and useful message to all economic agents, including foreign investors.

In October 1991, this chair had expressed its support for the policy of nominal exchange rate stability adopted by India since the previous devaluation in July 1991. We still consider that such a policy would help improve India's economic position. We hope, at the very least, that the dual exchange rate system recently put into place will be of a temporary nature. The elimination of temporary restrictions on imports put in place in the summer of 1991 is certainly welcome, and we strongly support the measures adopted for a substantial liberalization of the trade system.

More generally, in the field of trade liberalization, privatization, and the opening up to foreign investment, striking

progress has been realized. Efforts should be continued, aimed especially at formulating a comprehensive program of tax and public enterprise reform. We certainly support the pragmatic approach adopted by the authorities for increasing the role of the private sector in the economy. This approach should contribute to a reinforcement of the consensus in favor of the reform. Given India's efforts on adjustment and reform, the results already achieved, the maintenance of the debt repayment record and the authorities' readiness to adopt additional measures when needed, India strongly merits our support. We thus agree with the proposed decision.

Mr. Chen made the following statement:

I wish to commend the Indian authorities for the remarkable progress made since October 1991 in the implementation of the broad-based, Fund-supported reform and adjustment program. It is evident that the positive achievements are a credit to the authorities' determination and continued strong commitment to restructuring the economy. The process of rebuilding confidence and credibility has been broadly satisfactory. It is also obvious that the Fund has provided timely and valuable financial assistance to India when it was confronted with severe economic and balance of payments difficulties, and the staff is to be commended for its excellent work in this respect.

Because I am in broad agreement with the staff appraisal and Mr. Arora's opening statement, I would like to confine my remarks to the following: progress in the implementation of the program and India's economic performance is not synchronized. Although one cannot expect that it would be, I would be more reassured about the prospects for future growth if the structural benchmarks were primarily observed. Furthermore, it should be emphasized that the authorities are still confronted with the formidable task of completing the restructuring in the medium term.

Moreover, it should be recognized that what has been achieved so far in the structural areas may not be sustained or fully contribute to future growth if monetary conditions in the economy cannot be stabilized in a similar time frame. It is, therefore, crucial that the authorities make greater efforts to achieve their inflation target while continuing their endeavors to correct the distorted economic structure and to open up the economy more.

It goes without saying that monetary policy should be further tightened and, in fact, there is scope for doing so. However, while I stress the importance of a general tightening of monetary policy, I realize that this may be harmful to some sectors. Therefore, what is needed at this moment when there is still no

fundamental change in the way credit is allocated is a structural change in the direction of new credit--in the context of such a general tightening. The staff mentions one possibility in the staff paper on page 9, where credit to the Government will be reduced to provide adequate credit to the commercial sector. Does this mean that there is inadequate liquidity in the commercial sector while there may be excess liquidity in other sectors, such as the industrial or production sectors? The staff's comments would be appreciated.

In the fiscal area, initial progress has been made in consolidating the fiscal position. However, we note that progress has not been symmetrical on the budget. As implied by the staff, because of poor performance on the revenue side, the burden of consolidation is much heavier on the expenditure side, which may have unexpected side effects on other aspects of the program. It appears that some of the expenditure by the Government for social purposes may not necessarily have to be cut if improvement on the revenue side can be made. The delay in the tax reform may possibly be a factor in the less than expected revenue performance. The price of the delay is obvious. Therefore, I welcome the steps to be taken in the tax reform with respect to rationalizing the tax structure and broadening the tax base. In a sense the latter objective is even more important.

In addition, I note the actions taken to reduce subsidies on food and fertilizer. I wonder whether there is any possibility of eliminating all these subsidies in the medium term. I also welcome the maintenance of expenditure on social needs such as rural development and population programs envisaged as part of the 1992/93 Fund program. The authorities are also encouraged to make efforts to improve the federal-state financial relationship, with the aim of hardening the states' budget constraints and, especially, of reducing the states' reliance on the Federal Government.

With respect to the external sector, I note with satisfaction that fundamental changes have been taking place to liberalize trade and rationalize the exchange rate regime and that international reserves are building up. In this context, I can support the phasing out of the dual exchange rate.

Here, I note that the argument for a more appreciated official rate is that it will lower the cost of a few key imports, such as petroleum products and fertilizer. The authorities are expecting to phase out the dual exchange rate in two to three years, but I have some concern about how realistic such a phasing out is. First, the economy may still need to rely heavily on the importation of these items as long as domestic supply conditions remain unchanged. It is most likely that the resultant adverse



impact on the balance of payments and on the medium-term scenario may be significant, primarily because export earnings to pay for the importation of these items could not be fundamentally reduced. Therefore the balance of payments would still be vulnerable. Second, as asserted by the staff, balance of payments developments would determine the speed of phasing out the dual exchange rate. Therefore, prospects for a two- to three-year phasing out remain cloudy.

In this respect, developing India's import substitution capacity in the energy and fertilizer sectors--particularly in the oil sector--may be an important long-term solution. A joint exploration of India's oil potential would be predicated on the further development of foreign investors' confidence in India's future. In the meantime, prices on oil and fertilizer products need to be rationalized, and state energy enterprises need to be restructured to permit further exploration of India's potential in these fields. International financial institutions and international lenders should not withhold assistance at this juncture, when it is most needed.

Initial progress on structural reforms has been impressive. In particular, although conditions for financial liberalization are not yet all in place, the implementation of the stabilization program may provide a secure environment for financial reform. The planned scheduling of this reform is a step in the right direction.

In spite of unavoidable difficulties in moving ahead and deepening reforms in India, the authorities will eventually achieve their aim. In this respect, I encourage them to embark on an arrangement under the extended Fund facility (EFF). The program for 1992/93 is a credible continuation of what has been achieved and, therefore, merits our continuing support. With these remarks, I support the proposed decisions.

Mr. J. E. Ismael remarked that the Indian authorities had been reasonably successful in tackling India's internal and external imbalances and in maintaining economic growth. Nevertheless, inflation remained a major problem. The authorities' intention to reduce inflation from 13 percent to 8 percent in 1992/93 was therefore appropriate. To achieve that objective, the current broadly restrictive credit policy to slow down monetary expansion and strengthen liquidity management should be maintained. Equally important, all interest rates should be kept at a reasonable real positive level. To enable further liberalization of the interest rates, the financial sector should be further deepened and recapitalized.

He welcomed the objective of reducing the overall fiscal deficit further to 5 percent of GDP in 1992/93 through a substantial reduction in

net bank financing, Mr. Ismael stated. At the same time, it was reassuring to note the extensive tax measures that were being proposed, although the approach being adopted was somewhat gradualistic.

In addition to the macroeconomic adjustment efforts, structural reform should be undertaken with much more vigor, especially with respect to public enterprises, Mr. Ismael commented. Specific plans of action, directed at liquidating and privatizing unviable state enterprises, should be accelerated.

With respect to the exchange rate system, he urged the authorities to aim for a speedier elimination of the multiple currency practice and adoption of a unified exchange rate, Mr. Ismael said. He supported the proposed decision.

Mr. Mirakhor made the following statement:

When we last discussed India's Article IV consultation and its request for a stand-by arrangement, this chair, among others, expressed confidence in the ability of India's authorities and people to overcome the economic and financial crisis with which they were faced. It is heartening to note from the staff paper and from Mr. Arora's opening statement that this confidence was well placed and that the authorities reacted swiftly and decisively to restore domestic and foreign confidence in their handling of the economy. The Fund's staff and management should be commended for having contributed in an appropriate and timely manner to the authorities' efforts to stabilize the economy and for having convinced the international financial community of the authorities' ability to avert the crisis.

It is now quite clear that, had the authorities not reacted as strongly as they did, the crisis would have worsened; indeed, India's domestic and external imbalances were on a sharply increasing path. For fiscal year 1990/91, as shown in Table 2 of the staff paper, the overall public sector deficit reached more than 12 percent of GDP, while the external current account registered a deficit of 3 percent of GDP. Inflation, rapid growth of monetary aggregates, and investment as a percentage of GDP were at unsustainable levels. As a result, gross official reserves fell to the low level of a little more than one month of imports. This decrease endangered the smooth functioning of the economy and threatened the perfect record of India in servicing its foreign debt and, therefore, its continued access to financial markets.

In the event, the stabilization measures and the decisive structural reforms that were undertaken generally contributed to the reversal of these undesirable tendencies. For the current fiscal year, growth--although less buoyant than expected--is estimated to reach 2 percent, which is a good performance, given

the strong adjustment measures implemented and the decline in investment by more than 4 percent of GDP.

Inflationary pressures have proven stronger than anticipated, partly because of the unsterilized buildup in net foreign reserves and partly as a result of adjustment efforts. But the projected reduction in the overall public sector deficit is expected to be achieved, while the external current account deficit will be limited to 1.4 percent of GDP, as compared with the programmed 2.7 percent. The best performance pertains to the reconstitution of gross official reserves, which are expected to reach the level of 3.7 months of imports or 2.4 months more than programmed.

We are in broad agreement with the staff appraisal, and, given the good performance and favorable prospects under India's economic and financial program, we can support the proposed decisions on the review of the stand-by arrangement and on the temporary introduction of a multiple currency practice. Given the small magnitude of the deviation, we also have no problem in supporting the granting of a waiver for the performance criteria on the overall borrowing requirement of the Union Government for March 1992.

As to the program for 1992/93, we find appropriate the objective of reducing inflation to no more than 8 percent by the end of 1992/93 and providing for a modest recovery in economic growth. We concur with the authorities' emphasis on the continuation of fiscal consolidation and a broadening and deepening of fiscal reforms.

With respect to the overall fiscal deficit of the Union Government, the reduction to 5 percent of GDP will require courageous additional action on sensitive expenditure items such as subsidies and defense spending. With respect to capital spending and net lending, it is not clear to us what effect the reductions envisaged under the program--after the sizable reductions registered in the previous fiscal year--will have on economic growth. Because this budgetary item encompasses a broad spectrum of expenditures, we would like to hear some staff comments and, in any event, we encourage the authorities to deepen their fiscal reforms to enable them to re-establish a more appropriate share of capital spending to sustain private sector growth. We commend the authorities for their decision to protect from expenditure cuts a number of social programs that should be an essential part of the adjustment program in order to enhance the social and political acceptability of such a far reaching program.

On the external side, we are pleased by the better outlook envisaged for the balance of payments. This improvement is predicated mainly on a strong and sustained recovery of export volumes. Although we have confidence in the ability of the authorities to engineer such a remarkable turnaround, caution seems to be called for, given recent developments and prospects in the world economy and international trade.

As to the reforms in the external sector, we are pleased by the progress registered on the exchange rate system and in trade liberalization. We are cognizant of the constraints facing the authorities in these matters, which derive from decades of protectionist and dirigist policies. We continue, nevertheless, to hold the view expressed by this chair at our previous meeting on India that "a policy which focused more on the external competitiveness of the economy by means of a sustainable exchange rate policy, accompanied by a rapid reduction of tariffs, would be more likely to strengthen confidence."

We welcome the decisive and courageous steps already undertaken by the Indian authorities to redress the financial imbalances that developed in the recent past. We believe that their program deserves the full support of the Fund and the international financial community. We encourage the authorities to persevere in their efforts and to deepen and, where feasible, accelerate their structural reforms. However, to ensure full success of these reforms, we believe that the authorities and the Fund should, at an appropriate time, transform the present arrangement or conclude a future arrangement in the form of an extended facility or an enhanced structural adjustment facility.

Mr. Goos made the following statement:

We welcome the dramatic turnaround achieved by the Indian authorities in external confidence and the balance of payments position. Yet the overall picture is rather mixed in view of the fact that external adjustment has been achieved largely at the cost of severe import compression--mainly through administrative means--and a significant decline in investment activity. Equally worrisome is the unsustainably high level of inflation.

Against this background, it is rather clear that the eventual success of the authorities' stabilization strategy hinges critically on the mobilization of additional domestic savings to accommodate a recovery of investment while, at the same time, relieving pressures on domestic price and import developments. In the absence of decisive steps in that direction, there is a risk of a vicious circle between insufficient savings driving inflation and

higher inflation eroding savings, which, in turn, will adversely impact on the external accounts.

The necessary policy measures to prevent such an outcome which would, instead, build on the progress achieved so far, are in general adequately addressed in the staff paper before us. I can endorse its policy recommendations, including the staff's concern about the slow progress in formulating "comprehensive programs of action" "in a few areas."

In this respect, I should like to encourage the authorities, as I did during the 1991 discussion, to adopt a more ambitious timetable for the reorganization, rehabilitation, and privatization of public sector enterprises and for the reform of the financial system.

The rather slow pace of reform raises a general question on Fund policy, which I would like to pose to the staff--that is, what justifies the rather slow course of liberalization in the areas of quantitative import restrictions, unification of the exchange market, tax reform, and rationalization of India's pervasive bureaucracy when compared with the Fund's advice to formerly centrally planned economies. The Indian reform program is without doubt a far cry from the shock approach advocated for those economies.

Particularly worrisome are press reports---such as that in the Financial Times Survey on India on June 26--suggesting that the momentum of reform has already been lost, as powerful opposition lobbies seem to have weakened the Government's hand. More specifically, it is said that the reduction in fertilizer subsidies has been postponed and that the reform of the civil service, including staff retrenchment and wage containment, has even been put off the Government's reform agenda. This is, of course, rather disquieting in view of the importance of the reforms that need to be undertaken in those areas.

There was also an intriguing observation in the Financial Times Survey concerning the budget on which the staff might usefully comment; that is, that the budget target for 1991/92 "was achieved only with the help of accounting devices such as the postponement of the fertilizer subsidy payments." If accurate, this information would add to our general concern about budgetary developments, including the renewed significant cuts in spending for infrastructure and social services, which I understand were heavily criticized by the major donors at the meeting last week in Paris. Those cuts should be rapidly reversed and replaced by reductions in less productive spending, notably for defense. In doing so, the authorities should redouble their efforts at lowering the overall budget deficit, including the deficits of the

state governments, which, at a total of 8.5 percent of GDP projected for 1992/93, remain unsustainably high.

The overall fiscal deficit seems to be even higher than suggested by that figure, considering that the more appreciated official exchange rate--in combination with the existing export surrender requirement--appears to operate as a hidden subsidy for certain priority imports of the Government. Such subsidies normally are accounted for in the fiscal budget as expenditures. Needless to say, I strongly endorse the advice to unify the foreign exchange market as quickly as possible.

Could the staff comment on the risk that the inflation target might be missed again as a result of the delay in this year's monsoon rains, which is reported to have already caused widespread drought and damage to agricultural production?

Let me conclude by quoting another sentence of the Financial Times Survey, which cannot be overemphasized: "The external support now being provided by the World Bank, the IMF, and the donor nations provides India with a breathing space in which to carry out much needed structural change. The risk of not doing so is that India will drift into another crisis. There is an additional risk--that is, the risk that the Fund--notwithstanding its exemplary and successful operations in the early stages of the 1991 crisis--might be drawn into another protracted case of financial support. In this context, I would appreciate learning the staff's view on a possible request for an EFF and ESAF arrangements and, notably, whether the staff would consider the present pace of structural reform appropriate for such arrangements.

The Director of the Central Asia Department remarked that the staff agreed with Directors' comments on policies, and particularly the need to improve the quality of the fiscal adjustment, establish a social safety net quickly so that reforms could be accelerated, and unify the exchange market soon.

A number of measures were being prepared to prevent a repetition of financial irregularity in the banking system, the Director indicated. First, to strengthen supervision a separate unit would be created to take charge of bank supervision. Second, the modernization of banking procedures was being pressed. Third, an effort would be made to recover the assets that had been siphoned from the banking system. The fourth step--which had important microeconomic implications--was a strong statement from the Minister of Finance that there would be no budgetary assistance for any missing amounts. The banks would, therefore, have to turn to the market for their recapitalization.

The staff had continued to stress to the authorities the importance of restrictive financial policies to preserve a stable exchange rate, the Director said. If anything, the staff's emphasis on monetary policy had become even stronger. The pursuit of a stable exchange rate policy was the best course for India in the current circumstances, although the exchange rate did not need to be rigidly fixed. The trade liberalization that had already been implemented and the liberalization that would come might well push the equilibrium exchange rate down somewhat. Exchange rate policy should be sufficiently flexible to permit the rate to fall to a lower equilibrium level, if necessary.

Monetary growth had been much higher in 1991 than programmed, the Director recalled. The predominant cause was the large inflow of foreign exchange that had not, and could not, be effectively sterilized.

Directors had mentioned the need to phase out subsidies on fertilizer and petroleum and the difficulty that such action might pose in unifying the exchange rate, the Director recalled. The current exchange system did, indeed, provide the equivalent of a tax on exporters and a subsidy on fertilizer and petroleum product imports, which, for the time being, had been the main obstacle to unifying fully the exchange market; the Government obviously wished to be pragmatic in choosing the politically right moment when those price increases could be implemented. In 1991, the Minister of Finance had announced a 40 percent increase in fertilizer prices, which had exceeded the Government's policy objectives, but after much uproar and agitation, the price increase had to be reduced to 30 percent. The staff hoped that further steps could be taken within the next month to unify the exchange rate, which meant a reduction in subsidies.

The EFF program that would start next month would give a major impetus to reform, the Director of the Central Asia Department stated. It would have a substantial number of front-loaded measures and would accelerate the pace of reform within the constraint of the politically possible.

The staff representative from the Central Asia Department said that exports were projected to enjoy fairly buoyant growth on the order of 12-13 percent a year over the medium term. Such rates were quite plausible; they had been experienced in the second half of the 1980s, during the early stages of rather partial reforms. The staff had stressed to the authorities that that projection assumed further substantial changes in policies. He did not expect that such growth rates could be achieved under the current policy regime. In this context, three areas crucial for buoyant export growth needed to be emphasized. First, the trade liberalization to remove quantitative restrictions on tariffs would have to be continued. That liberalization would have a major impact on the system of price incentives. Second, continued fiscal consolidation to release the resources for a turnaround in the trade balance would be necessary. Third, the financial sector reform was crucial to export growth because--as several speakers had already mentioned--the lack of efficient financial intermediation and of

market-driven credit allocation had, in the past, been primary causes of inefficient investment in India.

The Director of the Central Asia Department, responding to a question on fertilizer subsidies, commented that the statement in the Financial Times, that the previous year's budget target was only met through accounting guises, was not valid. At the end of 1991, the arrears on payments for fertilizer had been larger than normal. That excess had been explicitly taken into account when calculating the budget deficit shown in Table 8 on page 23 of the staff report, where an adjustment had been made to the overall deficit on a cash basis and the excess of fertilizer arrears had been added in.

Mr. Goos remarked that he wondered to what extent the inflation rate target was realistic, given the drought, delayed monsoon, and other factors. There were even reports that, in some areas of India, civil unrest was threatening local governments.

The Director of the Central Asia Department replied that the decline in monetary expansion from 19 percent to 11 percent under the program was one important condition that would lead to a deceleration of inflation. Second, the projections assumed a normal monsoon. Currently, it appeared that the monsoon might be somewhat below normal, but it would certainly not be a catastrophe, as it had been in 1987. Therefore, the inflation target might possibly be met. In addition, the further fiscal consolidation that was intended would help achieve the inflation target. On the other hand, the planned administered price increases would make a tight financial policy all the more important to prevent secondary effects from those increases.

Mr. Mohammed made the following statement:

I would join other Directors in commending the Indian authorities for the significant progress made in stabilizing the economy and for beginning a rather long-range process of structural reform. While the fiscal effort in the period 1991-93 is strong, Table 5 of the staff paper projects rather modest improvements in the public sector deficit in the out years. I wonder whether the staff has a view on what it would regard as a sustainable level for the overall public sector deficit.

On the composition of the fiscal adjustment, I note a certain inconsistency between the view in the staff appraisal that spending on social services will have to bear a large part of the burden of cuts and the authorities' Memorandum of Economic Policies for 1992/93, which states in paragraph nine "...expenditure on social sectors and other core sectors of the economy will be protected from any cuts." Could the staff or perhaps the World Bank representative tell us what is the correct position?



The improvement in India's foreign exchange reserves has exceeded the most optimistic expectations. Nevertheless, it is well to remind ourselves that most of the improvement resulted from one-time gains rather than from fundamental improvements in the balance of payments. It is interesting to note that while the reserve target in the initial stand-by paper was 1.7 months of imports and was not expected to exceed two months of imports during the entire projection period, the staff now accepts a gross reserve target of over three months of imports as "necessary" to maintain confidence and protect the program from adverse shocks. My comment here is not meant to suggest that a higher reserve target is not desirable or necessary. I make this point to reinforce a suggestion I made in our discussion of international liquidity and the role of the SDR (EBM/92/79 , 6/24/92)), namely that the staff should be exploring broader measures of reserve adequacy than just import levels, taking into account the process of liberalization of foreign exchange controls, particularly on the capital account side, which we are experiencing in India and in my own country as well as in other developing countries.

On exchange rate policy, it is a matter of some regret that India was unable to adhere to its original intention of holding the nominal effective exchange rate stable following the July 1992 devaluation, despite certain assurances that were given in that regard. The new exchange rate arrangements, in our view, are an ineluctable consequence of the inability to back the policy of a nominal anchor with sufficiently decisive financial policies. I would here ask the staff a technical question: we are told that the appreciated official rate will apply to only certain essential imports. I understand, however, that all imports under the Asian Clearing Union arrangement can be made at the official rate, and this could be leading to various types of distortions; for example, traders in neighboring countries could be approached by Indian importers to place orders on their behalf in foreign countries with the understanding that the saving between the appreciated official rate of something IRs 26-27 per U.S.dollar and the market rate that the importer would have to pay--I suppose IRs 32--would be shared between the two parties. These kinds of distortions are an unavoidable consequence of a dual exchange rate arrangement. I would request some clarification of this issue as well as express a hope that the unification of the exchange rate system could proceed faster than the "two to three years" that the authorities mention in their Memorandum of Economic Policies for 1992/93.

I would like to emphasize a point on the balance of payments projections that has been made by other speakers. Export growth does seem to be overstated. The staff is projecting that, after an increase of only 4.4 percent in 1992/93, the growth rate would accelerate to 13 percent in volume terms and be sustained at that

level for the next three years. I have heard what the staff had to say earlier on the subject. This 13 percent rate, however, indicates that export growth would be something like two and a half times faster than GDP growth during the same period. In the recent past--for example, in the 1986-90 period--the elasticity of exports to GDP was only two thirds of that figure. Clearly the policy environment is changing, but the question of the realism of the projections remains, particularly because imports are assumed to be growing at a consistently slower rate. Given the pent-up demand for imports following the severe compression of 1991 and the very strong moves toward trade liberalization, I would think that the need to support an ambitious export target would require an equally ambitious import target.

Finally, the management of the capital account will remain one of the most difficult aspects of a liberalizing economy and will make the capital account vulnerable to shifts in confidence. We would like to underscore that schemes to encourage capital repatriation would only succeed in the context of continued tight domestic financial policies, which must remain the primary means of maintaining external confidence. With these remarks, I would like to support the proposed decisions.

Mr. Kafka said that the external adjustment part of the Indian program which the Board had approved in 1991 had been spectacularly successful, especially considering the far-reaching liberalization. The Indian authorities had acted throughout with courage and dispatch. The overshooting of the fiscal deficit for March 1992 was trivial, and the waiver proposed by the staff should certainly be granted.

Substantial further progress on fiscal consolidation was nevertheless required, Mr. Kafka stated. He agreed with the staff that there was room for revenue increases and that they were justified in seeking to avoid long-term cuts in infrastructure investment and social services. The revenue increases were particularly necessary because experience showed that in all countries public sector employment reductions and even the limitation of employment increases were notoriously difficult and slow to bring about. India was no exception. The need for additional fiscal restraint applied not only to the Central Government, but also to the states. The intended introduction of quarterly monitoring of state budgetary outturns was welcome and essential.

Monetary restraint was also essential although, as Directors knew, it must proceed in tandem with fiscal restraint, Mr. Kafka said. Otherwise, a familiar dilemma, under which capital inflows would offset conservative monetary policies aimed at control over net domestic assets, would endure.

The formalization of a dual exchange rate with progressively reduced limits on the spread between the free market and official rates must be

considered a welcome advance under current conditions, Mr. Kafka commented. However, the dangers of distortion remained significant as long as the spread between the two rates was as high as the maximum foreseen, even for March 1993. Another possibility of distortion should be guarded against through the abandonment of administrative tariff exemptions and, possibly, establishment of a minimum tariff. The Indian authorities should be congratulated on their progress, not only on adjustment, but also on the fulfillment of the structural benchmarks. He supported the proposed decision.

Mr. A. R. Ismael remarked that, like previous speakers, he wanted to commend the Indian authorities for the remarkable improvement in India's economic and financial situation over the past year under the stand-by arrangement. The bold and far-reaching measures implemented in the different sectors of the economy had undoubtedly helped the Indian authorities to overcome the external financial crisis that had erupted in 1991. He especially welcomed the measures taken in the area of trade liberalization and the general deregulation of private sector activity. Those measures would contribute significantly to increased output over the medium term.

Obviously, as the authorities themselves recognized, much remained to be done. The Indian authorities' strong commitment to continue the adjustment process--as reaffirmed by Mr. Arora in his opening statement--and the extensive list of measures envisaged that were detailed in the authorities' memorandum were reassuring. Although some reforms were being implemented rapidly, the authorities had appropriately taken a more pragmatic approach on other reforms--for example, in the banking sector, the public enterprise sector, and the exchange rate market. Given conditions in India, that approach had the best chance of success, as it would give the workers who would be adversely affected by the measures the time to adjust to new conditions and thus prevent excessive hardships.

Overall, he was in general agreement with the staff's analysis and recommendations and could support the proposed decisions. Continued success in the implementation of the reform program would require a significant amount of external financing on concessional terms over the medium term. In that respect, the intention of the authorities to request a "conversion of this current stand-by arrangement into an extended arrangement with a suitable blend of ESAF funding" was appropriate.

Mr. Mwananshiku made the following statement:

The Indian authorities should be commended for responding decisively to the sharp deterioration in economic and financial conditions in their country. The strong adjustment effort and the support of the international community, including the Fund, have put the Indian economy on firmer ground. Confidence has been restored, and international reserves have been built up to a level that could be considered somewhat comfortable, even though this achievement may have been at the cost of what Mr. Arora, in his

opening statement, has characterized as a crippling compression of imports. Progress has also been made in reducing inflationary pressures, although the rate of inflation remains high.

We are in broad agreement with the staff appraisal and can endorse the general stance of policy, which has strengthened the program in the second half of 1992. In particular, we would agree that the short-term focus on macroeconomic stabilization would have to emphasize policies aimed at bringing down further the rate of inflation. We would also encourage the authorities to deepen the structural measures already under way, in order to enhance economic efficiency.

The near-term focus on anti-inflationary measures means that the Indian authorities will continue to pursue tight financial policies, directed at continued fiscal consolidation, as acknowledged by Mr. Arora. We note that, in reducing the budget deficit in 1992/93, tax revenue is expected to benefit largely from the full-year impact of measures that the authorities put in place in 1991. At the same time, the anticipated recovery in imports is projected to boost customs revenue. However, it is not quite clear what would be the net effect on Government revenue of the tax measures that the authorities have recently introduced in the context of the 1992/93 budget, because some of these involve substantial reductions in tariffs and tax rates. In the medium term, the authorities should, indeed, be encouraged to emphasize revenue-enhancing measures to avoid reliance on expenditure cuts.

Thus far, the brunt of fiscal adjustment has fallen quite significantly on the expenditure side, with substantial cuts in capital outlays being tolerated for the second year in a row. These cuts are likely to have implications for future growth prospects. However, the reduction in subsidies and the progress being made on defence spending are welcome structural reforms of the budget, as indicated by Mr. Arora. For the medium term, the authorities are better advised to emphasize the containment of current expenditure. The authorities should also be encouraged to bolster the monitoring of government expenditure to facilitate effective control. The monthly tracking system recently put in place, together with the prospective quarterly reviews, should significantly improve monitoring procedures and allow the authorities to take prompt action when deviations threaten to derail the program.

Following the successful implementation of the short-term macroeconomic stabilization program, the authorities should be encouraged to address the more deep-seated structural problems in the context of a medium-term framework. In that connection, emphasis should be placed on the intensification and careful sequencing of the structural measures. Substantial progress is

already being made in the areas of parastatal reform, trade liberalization, and other important sectors for which the authorities should be commended. With these remarks, we support the authorities request for waivers and can, therefore, endorse the proposed decision.

Mr. Posthumus said that a crisis in India had been averted, but many problems remained to be dealt with. The Board should stress that the momentum for change must not be slowed, because, although the Fund program had been helpful--for example, in strengthening the foreign exchange position in 1991 and 1992--it could not be relied upon for many years to come; indeed, in two years' time, large Fund repurchases would start. Even more important, the large compression of imports, which Directors, particularly Mr. Arora, had noted, had been damaging for the economy and must be turned around as quickly as possible.

In the staff paper, the staff had mentioned the introduction of the dual exchange rate system but had not commented on it, Mr. Posthumus recalled. Forty percent of foreign exchange export earnings still had to be sold at the more appreciated official rate. The authorities intended to maintain the system for two to three years. He agreed with Mr. Peretz that a considerably more ambitious timetable for abolishing that system was needed.

The fiscal adjustment was strongly targeted toward expenditures, the review of which was obviously a somewhat longer-term operation, Mr. Posthumus noted. Tax reform had a high priority; a number of tax reform measures had already been incorporated into the 1992/93 budget. He wondered whether too much emphasis had been put on the reduction of tax rates, rather than on broadening the tax base, because the tax reduction's positive effect on total tax receipts was uncertain.

Mr. Végh remarked that he would like to commend the authorities on the significant progress that had been made during the past year. The program had been timely and successful. He agreed with Mr. Arora, who in his opening statement had said that "it is no exaggeration to say that in India today the debate is not about the direction of change, but largely about the speed and sequence, which are legitimate subjects for inquiry and dissent." However, he also agreed with many Directors about the need to follow the gigantic step that had been taken during the past year with very small steps. Mr. Arora had expressed the view that the many opponents of change worldwide, including bureaucracies and private sector special interest groups, would not state their opposition to change explicitly, but would try to slow the momentum for change wherever they could, especially given the liberal environment in the world and the fashion of the times. The Indian authorities should be concerned about such activity in India.

He agreed with Mr. Peretz and Mr. Fukui about the necessity of increasing the revenue base, and with Mr. Dawson and others about the level and

composition of central government expenditure, Mr. Végh stated. A large and complex society such as India needed a strong and sophisticated Central Government; therefore, expenditure cuts should be carefully studied. Perhaps the revenue base could be further improved.

Mr. Al-Jasser made the following statement:

Confronted with a severe economic crisis, the Indian authorities, in cooperation with the Fund, were able to design and implement a credible package of stabilization measures rapidly. These measures catalyzed substantial financial support from the international community and succeeded in overcoming the immediate crisis. This achievement is one that both the authorities and the Fund can be proud of.

As indicated in Mr. Arora's opening statement, the successful implementation of the program has led to a restoration of confidence and a rebuilding of international reserves. Nevertheless, the external position remains vulnerable, especially because reserve accumulation has occurred partly as a consequence of severe import compression. Moreover, I note from the medium-term outlook in the staff report that export volume growth is projected at 13 percent between 1993 and 1996. This impressive export expansion is predicated on a strong supply-side response, led by timely structural reforms. Hence, it is essential that the authorities maintain their enthusiasm for far-reaching and comprehensive structural reform even though the immediate crisis has abated.

In this context, I am somewhat concerned by the repeated references in Mr. Arora's statement to a period of two to three years for the implementation of crucial reforms. Indeed, by the time of this review, many of the program's policy measures were expected to be fleshed out and/or implemented. Furthermore, during the initial discussion of the stand-by arrangement, this chair, as well as many others, cautioned against any slippage in this timetable, or a weakening in the proposed measures. However, I note from the staff report that in the vital areas of public enterprise reform, tax reform, and exit policies, comprehensive programs of action will now be established only during 1992/93.

Although the authorities commendably met the fiscal deficit objectives, the persistence of high inflation highlights the need for further fiscal consolidation. The programmed reduction in Union Government expenditures is a step in the right direction. However, I note from the staff paper that the overall government wage bill has not been affected by the fiscal cutbacks of the past two years. The wage bill, along with public sector subsidies, represents opportune areas for further expenditure cuts. Hence, I welcome the authorities' intention to reduce the total labor force of unviable enterprises by up to two thirds. This restructuring

will be facilitated by the recently created National Renewal Fund, which will allow for the retraining and relocation of labor. Moreover, it is crucial that fiscal consolidation occurs at the state level. Here, I join the staff in urging the authorities to harden the states' budget constraints.

To strengthen the medium-term fiscal outlook, it is essential that the authorities move forward with comprehensive tax reforms that will broaden the tax base and eliminate existing loopholes and distortions. Also, it is imperative that public enterprise reform is vigorously pursued. This reform would lead to a reduction in public expenditures, a broadening of the tax base, and an improvement in overall economic efficiency. In the latter respect, the elimination of exit barriers is long overdue.

An acceleration in fiscal consolidation would ease upward pressures on interest rates, and, therefore, facilitate the conduct of monetary policy. Indeed, I note that the unsterilized buildup in net foreign assets led to an overshooting of the broad money target, despite the increase in interest rates and the introduction of an incremental cash reserve ratio. Hence, I welcome the authorities' intention to reduce sharply monetary expansion, and I urge them to tighten monetary policy even further, should the need arise. The authorities' ability to sterilize foreign exchange inflows and implement the new exchange rate arrangements would benefit from further progress in financial sector reform and the smooth implementation of open market operations. Both of these developments require additional flexibility in the determination of interest rates.

With respect to external policies, I commend the authorities on their trade liberalization measures, and I urge them to phase out, as soon as possible, the quantitative restrictions on consumer goods. More significantly, while I recognize that the adoption of an explicit dual exchange rate system represents a major improvement over the previous system of complex trade and exchange restrictions, I urge the authorities to speed up the unification of the exchange rate. The gain in confidence in the economy and the transparency of a unified rate should outweigh the costs.

In conclusion, the authorities have commendably implemented a strong stabilization program that has enabled them to overcome the immediate crisis. They have also initiated a program of structural reform that represents a clear break from past policies. The main challenge confronting the authorities is to ensure that their comprehensive structural reform program does not lag their impressive stabilization measures. Hence, I welcome the authorities' recognition that their reform measures are only an initial step in a far broader and deeper reform effort. In this respect,

any consideration of converting the current stand-by arrangement into an arrangement under the EFF should entail an explicit and clearly defined timetable for the implementation of public enterprise reforms, tax reforms, exit policies, and exchange rate unification. With these remarks, I support the proposed decisions.

Extending his remarks, Mr. Al-Jasser said that India had begun the stabilization process reasonably well, although much remained to be done, especially in terms of the revenue base. While expenditures as a ratio of GDP or GNP were not high for a society such as India, the ratio for the revenue side appeared to be low. Therefore, he wondered whether the staff had made any simulations of the Indian case and whether the emphasis should be on raising revenues or cutting expenditures.

India could afford to accelerate its structural reform, simply because India, unlike Russia, had a good base of entrepreneurial, private market-oriented traditions and capabilities, which needed to be unshackled, Mr. Al-Jasser commented. Public enterprise reform and allowing entry and exit into the private sector without the tremendous regulations and red tape that had existed would help. Unshackling the private sector could also be accelerated by the unification of the exchange rate and the liberalization of the financial sector. In Egypt, the unification of the exchange rate, even though there had been insufficient structural reform in areas such as the public sector, had made a considerable difference in terms of capital inflows and confidence in the economy, which hopefully would translate into more private sector investment, more foreign direct investment, and greater trust and confidence in the future of the private sector.

Mr. Solheim remarked that, like previous speakers, he was pleased to note that the immediate problems facing the Indian economy had been solved successfully by way of a substantial rebuilding of international reserves. Both the international community and the Indian authorities had done their part, thereby enabling the country to maintain its good payments record. Now, it was time for the authorities to build on that first step and lay the foundation for sustainable progress in order to reduce inflation, to create economic growth, and to attain external viability. Achieving those goals required persistence in the pursuit of economic policies designed to improve investor confidence and enhance the efficiency of the economy.

The key to stabilization was continued fiscal consolidation, Mr. Solheim commented. Progress in reducing the budget deficit had been achieved, but more needed to be done. As the staff noted, to avoid putting an unduly large adjustment burden on investment activities, the size of the public sector wage bill and the phasing out of subsidies would have to be dealt with. Moreover, measures should be taken to strengthen tax revenues. He agreed with the staff that more adjustment should be undertaken by the states. Further actions to harden their budget constraints seemed warranted.



On the monetary side, a more rapid liberalization of interest rates appeared desirable, Mr. Solheim stated. Furthermore, the large increase in the money supply in 1991 should not be allowed to recur. Restraining monetary expansion was essential to ensure a lower rate of inflation and strengthen confidence in the exchange rate.

The authorities should be commended for their efforts to liberalize the economy, Mr. Solheim said. Their policies constituted a sharp break from the past. Nevertheless, the authorities should accelerate the reforms. For example, the elimination of import restrictions over a time span of three to five years seemed too gradual. Like the staff, he was concerned about the slow pace in the implementation of reforms in certain areas. To enable India to reap the benefits of market reforms quickly, the authorities should increase their reform efforts. He fully supported the proposed decisions.

Mr. Marino said that, like previous speakers, he welcomed the important stabilization measures adopted by the Indian authorities. He would appreciate elaboration by the staff on the factors influencing inflation over the near term. The staff paper seemed to put too much emphasis on the growth of broad money. Perhaps there were other forces at work in the near term.

The Director of the Central Asia Department explained that the social expenditures mentioned in the Indian authorities' memorandum referred to a core social program, which was necessarily protected under the arrangement. Social expenditures and social services in a wider sense comprised approximately 8 percent of GDP--including both central government and state efforts; those expenditures had suffered in 1991 and 1992 in the course of budgetary adjustments. They needed to be restored and, indeed, increased.

Import payments from Asian clearing union countries could be made at the official rate, which led to the distortions that Mr. Mohammed had pointed out, the Director said. Those distortions should be removed--an action the staff had planned to discuss with the authorities.

The dual exchange system had been introduced in connection with a major trade liberalization; therefore, the staff viewed it as a vehicle to push ahead that liberalization for a transitional period, the Director stated. Both the authorities and the staff agreed that unification should come as soon as possible. The subsidization of certain imports was mostly a budgetary problem.

Perhaps, as Mr. Posthumus had indicated, the emphasis on tax rate reduction might be overdone, but in India it was not the tax rate that determined tax receipts so much as the efficiency of collection, the Director remarked. It had been shown that if rates were lower and exemptions were removed, the Government could actually collect more. Certainly, an examination of each individual tax might well reveal that some tax rate reduction might not be efficient.

As to the relative role of tax reform and expenditure cuts in the process of fiscal adjustment, the staff saw a need for both, perhaps in two stages, the Director indicated. In the first stage, the expenditure cuts would receive most of the emphasis; they could be more quickly implemented. In the second stage, more attention would have to be given to tax reform and revenue enhancement, which were necessary to offset the revenue losses, at least initially, from further tariff reductions and to finance the restoration of adequate levels of infrastructure and social expenditures.

Factors affecting inflation in the near term would include the pursuit of appropriate financial policies and a significant slowdown in the growth of the money supply, the Director of the Central Asia Department stated. Certainly, several supply factors would be at work. One positive factor had been the increased availability of imports. A potentially negative factor could be a less than normal monsoon. As he had mentioned previously, administered price increases would also have a one-time effect on the rate of inflation.

The staff representative from the Central Asia Department commented that the size of the fiscal deficit in the medium term would, to some extent, depend on India's decision on what the relative sizes of the public and the private sectors--particularly the relative sizes of public and private investment--should be. The medium-term projections, which were based on the current policy announcements of the Government, still assumed that the public sector played a sizable role in the Indian economy. It was essential for medium-term sustainability that the public sector deficit decline substantially faster than the external current account deficit, so that resources would be released for private investment in the new opportunities that would be created by the reform. Although the share of public debt in GDP was not as large in India as in some other countries, it had been rising significantly. The projections in the medium-term scenario provided for the increase in the debt ratio to taper off, followed by a decline.

In assessing the ratio of taxes to GDP and the size of the further tax effort required, it was important to bear in mind that India had a federal system of government, the staff representative said. Accordingly, the ratios given in the tables for the Union Government were only part of the total tax effort. In fact, those tables did not even include the revenue that was raised by the Central Government and passed on to the states. If the taxes raised directly by the states were included, revenue as a proportion of GDP was close to 20 percent. Therefore, the tax burden on the Indian economy was not small--a consideration when making decisions about the relative importance of revenue versus expenditure efforts.

Current projections of export growth were relatively optimistic, the staff representative from the Central Asia Department said. However, they were based on the assumption that the trade policies to be implemented in the coming period would be radically different from past policy. Two years ago, India had had one of the most restrictive trade regimes in existence

outside the centrally planned economies; in contrast, it was expected that the end result of the reforms would be a relatively open regime.

Mr. Posthumus remarked that the Director of the Central Asia Department seemed to agree with the Indian authorities that the dual exchange rate system should be abolished within two to three years.

The Director of the Central Asia Department replied that the Indian authorities intended to unify the exchange rate in a much shorter period, if possible. However, their official statement called for unification within two to three years. The staff had supported the goal of earlier unification.

Mr. Arora said that the Board discussion would encourage the Indian authorities and others outside the Government to press for a faster pace of reform. Mr. Peretz and many other Directors had mentioned that, in order to put reforms on a firm basis, it would be beneficial to have a medium-term framework for reform. Discussions between the staff and the authorities on an EFF program would begin in Delhi on July 22, 1992. The Board's critique of India's adjustment program was not surprising, because in India the view that the reform process needed to be expedited was growing.

The Financial Times item that Mr. Goos had read, to devastating effect, ill served the purpose, because such articles made a strong impression insofar as internal politics were concerned, Mr. Arora remarked. The Financial Times article did not capture the complexity of the political process in India in respect of reforms. Commentators tended to overpraise reform programs in the beginning. In India's case, it should have been obvious to all discerning observers, irrespective of what measures had been taken, that the measures announced initially were merely a first step. Subsequently, when some difficulties had arisen, those same commentators had adopted a pessimistic tone.

The apparent slowing down of the momentum had had an important political dimension, because the ruling Congress Party did not have an absolute majority in Parliament and did not possess complete control over the states; therefore, it had been compelled to defer to some elements in India's body politic in order to have its presidential nomination accepted, Mr. Arora explained. The President of the Republic, although a ceremonial figure, could play an important role. That election would take place in mid-July 1992. It was important not to introduce economic reforms at times when they would endanger the political stability of the republic, even though they might have great value.

The Minister of Finance had pointed out that the financial scandal had occurred because of inadequacies in the financial system, not its liberalization, Mr. Arora stated. As a result, there was even more reason for proceeding expeditiously with the program of financial sector reform, especially the effective supervision and regulatory practices that were

under way. Therefore, the suggestion that reform efforts were slowing down should not be given credence.

In response to concern about the political opposition becoming stronger and trying to slow down or reverse the reform process, Mr. Arora said that everyone in India recognized that the crisis in India continued. Whatever the media said, the Indian authorities were convinced that India could get out of the woods only by adhering to a program of reform, and that more, not less, reform was called for. They understood that the process of reform was never smooth anywhere.

There had been some special factors in the turnaround in India's external payments position, Mr. Arora noted. There had been an unfortunate, but necessary, compression of imports, and capital inflows had increased. However, the export growth had been minimal. Therefore, measures to strengthen India's external payments position were of paramount importance.

Directors' comments on fiscal consolidation were well taken, Mr. Arora remarked. Many in India who had urged the adoption of strong stabilization policies were now opposing new stabilization measures. India could not continue on the path of stabilization that involves cutting expenditures on capital investment, maintenance, and some important social sectors such as education, health, women, and nutrition. Other factors, such as subsidies, which were already being reduced, needed to be examined further. There should be a welcome reduction in subsidies before the second review. In addition, India had already reduced defense spending in real terms.

At some stage, the consensus building that had been going on in India had to result in concrete action, Mr. Arora remarked. However, that process was now in its infancy. In 1991/92, the Government had spent approximately Rs 2 billion to compensate workers who had been retrenched as a result of industrial restructuring. That expenditure was a recognition by the Government that industrial restructuring would involve the loss of jobs, but would have beneficial medium-term effects.

The pointed reference by Mr. de Groote to the rigidity of the labor markets in India was valid, Mr. Arora said. Directors understood the impact of labor market rigidities on the economy, owing to their familiarity with the European experience. In considering the appropriate pace of reform, Directors should consider the outstanding adjustment experience of Mexico. For six or seven years prior to the acceleration of the reform process in the past two to three years, Mexico had been implementing adjustment policies. Reforms took time. The Indian authorities were aware of the rigidities in the labor market, and flexibility in the labor market would come at the appropriate time. Despite the labor market rigidities imposed by laws, most private sector units were able to manage the rationalization of labor or its direct retrenchment. The authorities would review the remarks made by Directors. There was evidence, too, that the structural reform process had to be accelerated. Therefore, when the Board next considered India's program, India should have not only a credible set of policies, but also

performance indicators to show that it was moving in the right direction. His intention in quoting Mexico's example was not to plead for unnecessary delay, but to say that owing to India's vast diversity--ethnic, religious, and linguistic--the authorities had to weigh at every stage how far they could go.

In March 1992, the Government had made explicit the dual exchange rate system, which had previously been implicit, Mr. Arora said. The advantages and disadvantages of that system were evident. The major reasons for the Government to wait to unify the exchange rates were the need to assess the shape of the monsoon and to avoid an increase in inflation. Politically, inflation in India was a serious problem with regard to which the Government had to exercise much sensitivity, even though it was only 13 percent. If the monsoon was bad and the food output was depressed below 1991/92 levels, there could be serious budgetary problems. India was going to put more transactions on the open market. The proportion of such transactions available to exporters had increased. The authorities were likely to unify the exchange rates much sooner than the two to three years called for under their cautious official policy stance.

The Executive Board approved the following decisions:

Review Under Stand-By Arrangement

1. India has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for India (EBS/91/176, Sup. 3, 11/6/91) and the third paragraph of the letter of the Minister of Finance dated August 27, 1991.

2. The letter of the Minister of Finance dated June 2, 1992 with the attached Memorandum of Economic Policies for 1992/93 shall be attached to the stand-by arrangement, and the letter dated August 27, 1991 with the attached Memorandum on Economic Policies for 1991/92-1992/93 shall be read as supplemented and modified by the letter dated June 2, 1992 and attached memorandum.

3. Accordingly:

(a) Paragraph 2(a) of the stand-by arrangement shall be amended to read as follows:

"(a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 732 million until August 15, 1992; the equivalent of SDR 963 million until November 15, 1992; the equivalent of SDR 1,194 million until February 15, 1993; and the equivalent of SDR 1,425 million until May 15, 1993."

(b) Paragraph 4(a) of the stand-by arrangement shall be amended by adding the following subparagraphs (iv) and (v) immediately before "described in Table 1...not observed; or":

"(iv) the limit on the commercial foreign borrowing by the public sector, or

(v) the limit on short-term outstanding external debt,"

(c) The limits and floor referred to in paragraph 4(a) of the stand-by arrangement, as amended by this decision, shall be as specified in Table 1 of the memorandum attached to the letter dated June 2, 1992.

(d) Paragraph 4(b) of the stand-by arrangement shall be amended by substituting "November 14, 1992 and May 14, 1993" for "August 14, 1992 and February 14, 1993."

(e) Paragraph 4(c)(ii) of the stand-by arrangement shall be amended to read as follows:

"(ii) introduces or modifies multiple currency practices, other than the modifications to the dual exchange rate system described in paragraph 24 of the memorandum attached to the letter dated June 2, 1992."

4. The Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement is completed and that India may proceed to make purchases under the stand-by arrangement, notwithstanding the nonobservance of: (i) as of March 31, 1992, the performance criterion on the limit on the overall borrowing requirement of the Union Government set forth in paragraph 4(a)(i) of the arrangement and (ii) the performance criterion on the introduction of multiple currency practices referred to in paragraph 4(c)(ii) of the arrangement.

Decision No. 10063-(92/82), adopted  
June 29, 1992

#### Exchange System

India has introduced a multiple currency practice arising from the temporary establishment of a dual exchange rate system. The Fund grants approval for the introduction and retention of this multiple currency practice until November 30, 1992 or the time of the next Article IV consultation, whichever is earlier.

Decision No. 10064-(92/82), adopted  
June 29, 1992

3. TUNISIA - 1992 ARTICLE IV CONSULTATION, AND REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with Tunisia and the review under the extended arrangement approved on July 25, 1988 (EBS/92/93, 5/27/92). They also had before them a statistical annex (SM/92/116, 6/15/92).

The staff representative from the African Department reported that, based on preliminary information provided by the Tunisian authorities, the end-May 1992 performance criteria had been observed. In particular, the net foreign assets of the Central Bank had amounted to SDR 259.4 million, compared with a floor of SDR 146.2 million. According to provisional data, domestic credit had stood at D 7,184 million, or D 100 million below the ceiling, while net credit to Government had been limited to D 812 million, or D 144 million below the ceiling. The performance criteria relating to short-term official borrowing and external payments arrears had also been observed.

The restrained financial policies had been reflected in a continued slowdown in inflation, the staff representative said. During the first five months of 1992, the consumer price index had risen by only 1.6 percent, compared with 2.5 percent during the corresponding period of 1991. On a 12-month basis, the rate of increase in the consumer price index had fallen from 7.1 percent through December 1991 to 6.1 percent through May 1992.

As envisaged under the program, the Central Bank had, on that day, issued circulars to the commercial banks raising the preferential interest rates by 1 percentage point, the staff representative from the African Department noted. That action brought the rate to a range of 10-11 percent, which was close to the money market rate of 11.8 percent.

Mr. Mirakhor made the following statement:

After more than five years of arduous, forceful, and steady adjustment, the Tunisian economy has achieved a considerable degree of stability and resilience. Along with the sound fiscal and monetary policies, substantially reduced economic distortions, and improved incentive structure that have strengthened the domestic economy, appropriate exchange and trade policies combined with prudent debt-management policies have buttressed the external sector. Thus, the economy is now in a position to experience sustainable and stable economic growth in the period ahead. My Tunisian authorities concur with the assessment of the economic and financial performance of the economy provided in the staff report and are appreciative of the cooperation they have received from the staff in their adjustment efforts.

Tunisia's adjustment program, introduced in the second half of 1986, was formulated in the context of a medium-term strategy

covering the period 1987-91. The first phase of the program was designed to alleviate the unsustainable financial pressures experienced in 1986. This stabilization aspect of the program was successfully completed under an 18-month stand-by arrangement coupled with a drawing under the compensatory financing facility. The second phase of the program was formulated in the context of a three-year extended arrangement supporting structural and financial reforms aimed at attaining balance of payment viability and sustained growth. The overall results achieved under the extended arrangement were so encouraging that the authorities decided not only to refrain from drawing under the arrangement but to request a reduction in access of 50 percent of quota on the occasion of the third review in May 1990. However, with the outbreak of the Middle East crisis and in order to contain the demand pressures generated by the strong economic recovery in 1990, the authorities requested a lengthening of the extended arrangement to a fourth year with a view to achieving the original macroeconomic objectives of the arrangement.

The adjustment of the economy was aimed at reducing the external and internal financial imbalances through the implementation of prudent fiscal and monetary policies. As a result of the authorities' adjustment efforts, the current account deficit is expected to be reduced to 2.6 percent of GDP at end-1992 from 8.0 percent in 1986, and the budget deficit is to decrease from 4.6 percent to 2.5 percent during the same period. Economic growth will have averaged 4.8 percent during this period, against a decline of 1.1 percent in 1986, and inflation is to be contained at about 6.5 percent at end-1992 despite the large impact on the consumer price index of price liberalization and substantial reductions in subsidies. Moreover, the authorities' cautious external debt policy will result in a reduction in the debt-service ratio to 20.4 percent in 1992, from 27.9 percent in 1986, and in the debt/GDP ratio from 63.0 percent to 52.7 percent during the same period. Among other positive developments, it is worth noting that economic diversification and improved competitiveness have yielded substantial gains, reflected in the surge in non-energy exports that more than compensated for the fall in petroleum exports.

As to the period ahead, my Tunisian authorities will continue their close collaboration with the staff even after the expiration of the current arrangement. They have already agreed on a medium-term macroeconomic framework, detailed in Appendix III to the staff report, which forms an integral part of the Eighth Development Plan covering the period 1992-96. In addition, understandings have been reached with the staff on quarterly benchmarks for key macroeconomic indicators for the second half of 1992. The program includes a comprehensive set of structural



policies that are well documented in my authorities' letter of intent, as well as in Table 1 of the staff report.

My authorities share the staff analysis with regard to the remaining challenges. They will vigorously pursue their reform efforts in 1992 and over the medium term and will be guided by the recommendations contained in the staff appraisal and by Directors' remarks and observations. They would like to underscore the particular importance they attach to the promotion of the private sector. This attention has been recently reinforced by the creation of a Ministry of International Cooperation and Foreign Investment, which the authorities hope will contribute to intensifying non-debt-creating flows to Tunisia.

At present, Tunisia is in the process of finalizing a syndicated loan with a consortium of international banks in an amount of \$110 million. My authorities believe that their success in gaining the confidence of the international capital market owes much to the efforts of the Fund and the World Bank. I take, therefore, this opportunity to convey their appreciation to the Executive Board for its continuous support and to Fund management and staff for their assistance.

Mr. Mohammed made the following statement:

Tunisia's economic performance since 1987, when the country embarked on a comprehensive program of economic reform, has been impressive. Among the key factors behind this record has been the authorities' strong commitment to the adjustment process and their ability to adapt policies in the face of exogenous shocks. Output growth has been sustained, inflation held to moderate levels, and the external sector position strengthened. Progress in the structural area has been noteworthy, particularly as regards price and import liberalization, the restructuring of the financial system, and privatization.

In many respects, performance in 1991 has turned out to be even better than expected. Output growth was positive, despite a sharp fall in tourism revenues, and there has been a continuing slowing down of inflation. The balance of payments and reserve positions improved on the strength of a strong showing in the export sector. Despite the strong performance of tax revenues, the fiscal target was missed by a small margin, owing in part to higher interest payments on domestic debt in the context of financial sector reform. Based on the information provided by the staff representative, all end-May performance criteria are likely to have been met.

The authorities' interest in continuing to maintain close contact with the Fund on the general direction of their policies is once again a measure of their commitment to pursue with determination their program of adjustment and structural reform.

The authorities' economic and financial policies for 1992 are appropriately set against the backdrop of Tunisia's Eighth Development Plan. This Plan aims to move Tunisia into a higher sustainable growth path so as to secure a lasting improvement in per capita income and to expand employment opportunities in an environment of continued financial stability. Both investment and the efficiency with which resources are to be deployed are set to increase markedly in response to a more neutral incentive framework, a further deregulation in the goods, capital, and labor markets, and the progressive liberalization of the foreign trade and payments system. The importance of seeing these reforms through, both in 1992 and over the medium term, is underscored by the key role that a rise in the domestic savings rate plays in ensuring the long-term viability of the balance of payments. Table V in Appendix I of the staff report shows the gross domestic savings ratio rising from 18.7 percent in 1991 to 25.6 percent in 1996, an increase of 7 percentage points of GDP, of which 3 percent is to come from the efforts of the Central Government and another 4 percent from a rise in the private savings ratio. These are very large increases, and I am assuming that the Eighth Development Plan does not partake of the kind of models in which the domestic savings rate is the residual adjusting variable in the system.

The implementation of the 1992 program will be an important first step toward meeting the objectives set out in the Plan. I welcome the authorities' intention to maintain firm fiscal and monetary policies, while concurrently broadening the effort in the various areas of structural reform to enhance the overall efficiency and competitiveness of the economy. The authorities are aware of the challenges they face, and the potential risks, but I am confident that, as in the past, they will persevere in their efforts.

With respect to the medium-term balance of payments outlook, Tunisia's external sector prospects appear to be quite robust in the sense that even under a more pessimistic set of assumptions--the simulation of drought shock--the country should be able to absorb the external shock without resorting to exceptional financing. But in looking at the baseline scenario, one thought comes to mind: the export growth target, especially its non-oil component, hinges on the expected positive impact of a broad range of structural reforms. While I am confident that these reforms and the associated supply response will be forthcoming, I am less inclined to simply assume--as the staff appears to do--unhindered

growth in Tunisia's external market share for manufactures, given its heavy concentration of exports to Europe and the uncertainty surrounding developments there. Does the staff have a basis for its view that a further gain in market shares can be achieved?

I can certainly agree with the need to follow a prudent wage policy and to combine this with steps to encourage greater labor market flexibility and higher productivity. This would be an important adjunct to preserving Tunisia's external competitiveness through reliance on aggregate demand-management policies and structural reforms. However, the data on the movement in real wages in recent years--Table 13 of the Statistical Annex--suggest that Tunisia's wage policies do not appear to have been a cause for undue concern; in fact, it could be suggested that they have been far too austere. The data show that real wages in the "formal sector"--and I assume that the data are aggregating the experience of the public and private sectors--have actually declined in four of the past six years.

I therefore have two questions. First, I wonder whether the staff can provide separate information on real wage trends for the public and the private sectors. The impression given from the staff report is that it is perhaps in the public sector that wage settlements might have been excessive in the sense of being out of line with productivity advances. Second, the secular decline in real wages against the background of a growing economy is perplexing and needs to be explained. Perhaps the staff could provide us with some analysis, given the crucial importance of preserving public support for the reform effort, a point to which the staff rightly draws attention in its appraisal and with which we strongly concur.

Mr. Bonzom made the following statement:

The expiration of a Fund agreement is always a good opportunity, first, to look back at the progress that has been achieved, and second, to look ahead at the challenges that must be met. During its extended arrangement, Tunisia suffered from two important shocks. First, a major drought significantly reduced the level of agricultural production. Second, the Middle East crisis provoked, inter alia, a reduction by one third in the yield of the second source of foreign currency, the tourism sector. We fully concur with the staff that, in spite of these adverse exogenous shocks and of the transitory disturbances that are inherently linked to the implementation of substantial structural reforms, Tunisia has made considerable progress toward sustainable growth.

In 1991, the economy grew at a rate of 3.5 percent--a performance that is much better than the near stagnation incorporated into the program--without jeopardizing the main financial equilibria. Indeed, inflation and the public deficit only slightly surpassed the targets. Money growth was in line with the program's goals. The current account deficit was reduced, owing largely to a strong export performance, by more than 1 full percentage point of GDP compared with the 1990 outcome. Also, as noted by the staff, Tunisia succeeded, during the course of its extended arrangement, to maintain its impeccable debt payment record and to bring its debt ratios to somewhat more manageable levels.

These positive performances are linked to the prudent economic stance adopted by the authorities and to their capacity to react promptly to the evolution of their economic environment. Such caution and adaptability are--and will remain--prerequisites for economic management, especially in the case of an economy of Tunisia's size. They will also be particularly needed to achieve the well-taken aims contained, as noted by Mr. Mohammed, in the Eighth Development Plan, namely, the growth in per capita income and employment, the reduction in the inflation differential, and the strengthening of the external position. The new plan period will mark the return of the trade balance on energy products to a deficit, epitomizing Tunisia's entry into a new era in which development will hinge primarily on the consolidation of a framework conducive to enhancing private sector activity.

It is with these challenges in mind that I would like to review briefly the main areas of economic policymaking: the need to monitor carefully future budgetary developments; the importance of continued restraint in monetary policy; and the next steps for structural reform.

The slight slippage in the 1991 budget deficit must not distract our attention from the progress made in terms of improving tax administration, widening the tax base, and reducing--by 22 percent in two years--consumer subsidies. However, as correctly stressed by the staff, this slippage points to the need to carefully monitor further developments in both revenues and expenditures.

On the revenue side, broadening further the base of the value-added tax and strengthening tax administration will be essential. Continued determination in improving the financial situation of public enterprises will also help, in the medium term, to generate new resources for the budget. Such actions on the revenue side will be useful, but control of outlays will be critical. Tunisia's track record is already impressive in this area; indeed, during the past three years, expenditures have been

reduced by 3 percentage points of GDP. For the future, we welcome the authorities' intentions to continue the reduction in consumer subsidies, to enforce a better targeting of the social safety net, and to conduct a review of employment in the civil service.

Much progress was registered in internal monetary developments during 1991. Monetary growth ceilings were observed, and the inflation rate objective was surpassed slightly, mainly on account of increases in various taxes. The authorities' intentions to continue developing financial instruments, to introduce open market operations, and to completely eliminate preferential interest rates by the end of this year are welcome. The authorities must be commended for having maintained real interest rates at positive levels. As mentioned in the letter of intent, it will also be important to allow interest rates to play a greater role than in the past in clearing the money market.

The authorities have succeeded in maintaining a fairly stable nominal exchange rate over the past two years. The slight increase--by 3 percent last year--in the real exchange rate has not prevented non-energy exports from rising steadily over the period. In view of, first, the overwhelming share of Tunisia's foreign trade that is carried out with the European Community; second, the crucial importance of attracting foreign investment; and third, the need to bring about a further reduction in the inflation differential, I wonder whether a more formal pegging of the dinar--with appropriate fluctuation margins--could not be considered an option for the medium term. I would welcome comments by the staff on this issue.

The Tunisian authorities have moved steadily in the area of structural reform, and they should be commended for, inter alia, the first steps taken in implementing their privatization program, the liberalization of foreign trade, and the increased integration of environmental concerns into their decision-making process. Further progress will be necessary, especially in the following areas: first, the further liberalization of prices and margins; second, the continuation of performance contracts with public enterprises; and third, the simplification and modernization of regulations concerning labor and investment, including foreign direct investment.

We are confident that Tunisia will continue, after the extended arrangement, the consolidation of the good results it has achieved so far and its progress toward a sustainable growth path. We thus support the proposed decisions.

Mrs. Hansen made the following statement:

Tunisia is often cited as a relatively good economic performer. Indeed, export performance and average GDP growth have been reasonably strong in recent years; macroeconomic imbalances, although larger than desirable, are not overwhelmingly large; gradual progress is being made on structural reform; and Tunisia has maintained its international creditworthiness. This record places Tunisia among the top performers on the continent. Be that as it may, we continue to be of the view that this is not the proper comparison, given Tunisia's considerable development potential. While we recognize and commend Tunisia's achievements, we continue to believe that the authorities should set their sights higher--on more complete macroeconomic stabilization and more rapid structural reform. With regard to macroeconomic stabilization, we have some questions about the lack of progress in reducing domestic inflation. In 1986, when the stabilization effort began, inflation averaged 6.2 percent. Although inflation has declined more rapidly than expected in the first five months of the year, the 12-month rate is now essentially where it stood in 1986 when the stabilization effort began. Unfortunately, the staff report provides little discussion of the causes for this performance.

Passing mention is made of the role of price liberalization and the reduction of subsidies; we do not doubt that these contributed to inflation, but it is unclear that they were the determining factors, especially since annual progress in freeing domestic prices has been so halting. Perhaps more to the point is the fact that trade liberalization is still at an early stage. That only 45 percent of domestic production is subject to import competition suggests that international prices probably have only a limited moderating effect on domestic price formation. In fact, we wonder whether there is not a sequencing problem. With domestic price liberalization apparently proceeding at a somewhat faster rate than international trade liberalization, we wonder to what extent protected domestic industries are exploiting monopoly positions.

It may well be that the authorities' reluctance to liberalize trade faster has to do--at least in part--with their desire to protect Tunisia's external position. If so, this is an understandable concern, but one which suggests the need for tighter financial policies to restrain domestic demand, rather than a restrictive trade policy.

In the same vein, we note that the 1992 wage settlement, the third of a three-year agreement, calls for an increase of 12.3 percent. This is well above actual domestic price increases of recent years and no doubt is a further contributing factor in

inflation. We wonder to what extent the generosity of the wage settlement is an indication that inflationary expectations remain relatively high and that the government policy stance has been insufficient to dispel them.

Also, the gradual exchange rate depreciation required to keep Tunisian exports competitive has no doubt contributed to domestic inflation as well. This is certainly not a problem of exchange rate regime--with other policies as they are, we believe that the Tunisian authorities are correct in preserving the flexibility needed to maintain exchange rate competitiveness. However, we believe that it would be to Tunisia's advantage--in terms of lower inflation and greater confidence in domestic economic management--to run policies that obviate the need for continued depreciation.

Looking ahead, the Tunisian authorities have the ambitious medium-term objective of attaining convertibility for the Tunisian dinar. We support their aim, but it is not clear how they will achieve it without stronger financial policies to strengthen Tunisia's external position, build up reserves, and enhance confidence in domestic economic management. In this connection, the staff has made a number of appropriate recommendations about containing domestic expenditure and improving tax revenue that I will not repeat here, except to highlight the need for fewer, but better-targeted, subsidies, resulting in a more effective social safety net. At the same time, it would be desirable to intensify structural privatization and financial market reform.

On the authorities' request, Tunisia has met its performance criteria for end-December and gives every indication that end-May criteria will be met as well. On this basis, we can support the request. However, the staff report should have been clearer on the reasons for this unusual bunching of three disbursements, which are to be made virtually simultaneously at the end of the program period. Likewise, we were surprised to see no mention of the fact that the end-March performance criteria called for in the program were never set and no explanation of the circumstances that have led to the Board's simultaneous consideration of end-May criteria and the preliminary end-May data suggesting that these criteria have been met. We assume the timing has to do with the delay in concluding the final review, but we would appreciate some further clarification from the staff.

In conclusion, we commend the authorities for Tunisia's performance. We also welcome the authorities' intention to set indicative targets beyond the program period. However, we continue to believe that the Tunisian economy could perform still better, and we hope that the authorities will find the opportunity to accelerate domestic reform.

Mr. de Groote made the following statement:

Since the beginning of its implementation of the Fund-supported program, Tunisia has achieved commendable results. As in any country undergoing systemic reform, the necessary transformation of the economy cannot be accomplished overnight, and it is therefore not surprising that some major objectives still remain to be realized.

GDP growth resulting from increased investment, mainly in the textile, leather, transport, and communications sectors, has been a key factor in this success. Tunisia is to be commended particularly for accomplishing this result despite the Middle East crisis of 1991 and a leveling off of tourist revenues. The relative constancy of investments in the tourism sector would seem to reflect the Government's realization that capacity in this area has reached the point of relative saturation, as predicted by previous World Bank studies indicating that further increases would soon exceed the sector's capacity to absorb them.

It is urgent to keep the savings-investment gap of the Central Government under close control. It would be interesting to learn from the staff whether the widening of this gap, which was minimal at the beginning of the program but has since increased to nearly 4 percent, could be attributed to the decrease in total fiscal revenues. This decrease may stem from excessive reliance on import taxes as a source of fiscal revenues. Would it have been impossible to shift the tax base further in the direction of domestic production? Perhaps the planned broadening of the value-added tax will provide a solution.

Tunisia's most persistent problem, of course, is its trade deficit, even though there has been significant progress toward increasing trade in such specialized areas as leather goods and textiles, which are both labor-intensive industries where Tunisia has a clear comparative advantage. I wonder whether this success has not been accompanied, in the past two years, by some policies of substitution in the areas of food and energy, since in the case of energy, and to a lesser extent in the case of food, the statistics indicate a decrease in both exports and imports.

In any event, Tunisia's economic performance has been most encouraging. Indeed, ever since Tunisia began, with the Fund's help, to apply its new economic policy, soaring foreign direct investment has demonstrated a general increase of confidence in Tunisia's private sector. These achievements may be summarized by saying that Tunisia has shown, more clearly than many countries far richer in natural resources, that a rational economic policy is still the key to economic adjustment and growth.



The staff representative from the African Department remarked that, under the Eighth Development Plan, non-oil exports were projected to grow by an average of 9.6 percent annually, although export volume, excluding oil and phosphates, had, during 1986-91, reached about 15 percent annually. Clearly, the projections showed a smaller rate of growth for exports than had been the experience thus far. As Mr. Mohammed had indicated, much of the supply response within the economy was expected from the increased incentives provided by the ongoing structural reforms. The authorities also expected that the aggressive marketing that had characterized entrepreneurs in Tunisia over the past five years would continue in the period ahead. Tunisia's relatively small share of European markets was not expected to place a significant constraint on its export potential.

Wage policy should be considered in a broader context, the staff representative commented. The three-year agreement reached with the labor unions had provided for average wage increases of about 5.6 percent annually during 1990-92. Those increases, in fact, had been lower than the rate of inflation recorded during the period. The authorities believed that the three-year agreement had avoided annual negotiations with the labor unions and had contributed to a high degree of social calm in Tunisia; they recalled that, following a period of rapidly rising real wages, notably in 1979-83, which had contributed to Tunisia's economic and financial crisis, an austere incomes policy had been implemented in 1984-88 to stabilize the situation and bring inflation under control. During the three-year period of the extended arrangement, real wages had increased marginally in the salaried sector, having risen by only 1 percent in 1989, declined by 1 percent in 1990, and increased by 2.5 percent in 1991. However, the high growth rate implied that per capita income in the nonsalaried part of the economy had increased more rapidly.

As to whether the wage agreement provided for both cost-push and demand-pull inflationary pressures, the authorities had viewed the agreement as essentially restraining wage increases over the period, the staff representative continued. They considered the increase in employment opportunities in Tunisia more important than the issue of wage increases. They also believed that an austere wage policy would help to reduce inflationary pressures over the medium term, improve the competitiveness of the economy, and increase employment opportunities.

The authorities' efforts on price liberalization, subsidy reduction, and various realignments of the exchange rate--during the period, the exchange rate depreciated by about 27 percent in real terms--had contributed to keeping inflation at 6.7 percent, the staff representative commented. While opening up the economy would, in due course, help to reduce inflationary pressures, it would have to be accompanied by tight fiscal and monetary policies. Throughout the period, monetary policy had been very restrained; the growth of money supply had been significantly lower than that of nominal GDP, in an attempt to dampen inflationary pressures.

Fiscal adjustment in Tunisia had been rather limited, the staff representative said. The fiscal deficit, while not excessively high, had not been reduced significantly during the period. Mr. de Groote had pointed to the savings-investment gap as the main reason. There had been a strong shift away from taxation of imports, which had been subjected to high tariff rates of several hundred percent in the mid-1980s, promoting inefficiency in domestic production, and tariffs had been reduced to the current average rate of 27 percent. A significant effort was being made to shift to domestic taxation--although not as quickly as desirable--particularly through the introduction of the value-added tax and a general income tax. The coverage of the value-added tax would have to be expanded during the period ahead, and tax administration would have to be strengthened further, as domestic taxation had proved to be complex.

Food exports had increased significantly during 1990-91, owing mainly to good weather conditions, the staff representative reported. A tapering off was projected for 1992 because another bumper crop was not expected. On petroleum exports and imports, a policy was in place to enhance Tunisia's refining capacity so as to increase locally produced petroleum that was refined and processed in Tunisia.

With respect to exchange rate policy, the currency was pegged to a basket, managed by the Central Bank, which included three major currencies, although the makeup of the basket was confidential, the staff representative explained. Through adjustments, the Bank had managed to maintain the real effective exchange rate approximately constant over the past couple of years. The authorities wished to support the exchange rate with policies to reduce inflation and increase competitiveness. The medium-term projections that had been provided in the context of the Eighth Development Plan indicated that the authorities hoped to achieve, by 1996, an inflation rate that would be consistent with that of their main trading partners.

On the phasing of disbursements, under the program it had been envisaged that the authorities would be able to draw upon observance of the end-December performance criteria and upon completion of the review, which should have taken place earlier, the staff representative from the African Department said. The authorities had wanted to postpone conclusion of the review until the work on the Eighth Development Plan was sufficiently advanced to form a basis for discussions with the Fund staff; two notifications had been circulated to the Board providing reasons for the delay. The bunching of the last two purchases following observance of the end-May performance criteria arose because that was the last test date for which data would be available before the expiration of the extended arrangement. He recalled that during the previous Board discussion on Tunisia (EBM/91/94, 7/17/91) there had been considerable discussion as to whether consideration should not have been given to semiannual performance criteria under the extended arrangement.

Mr. Martínez-Alas made the following statement:

The Tunisian authorities deserve to be commended for their commitment and perseverance in the implementation of their adjustment program since 1986, in response to the growing macroeconomic imbalances faced by the Tunisian economy at that time.

Notwithstanding more than six years of bold measures, the Tunisian authorities must continue their efforts, especially in the areas of structural reform and institution building, to consolidate the gains already made. In this sense, we strongly agree with the staff assessment that "in the period ahead, the Tunisian authorities face the challenges of raising living standards and expanding employment opportunities by sustaining a high rate of economic growth under conditions of financial stability." Meeting this challenge will surely take time. We would like to emphasize, in this connection, the time span required by Tunisia to approach domestic and external viability. Tunisia's case highlights the need and value of continued international support for countries implementing strong adjustment programs. Only with sufficient time and support can countries implement far-reaching adjustment programs as the Tunisian case seems to show.

It is highly satisfactory to see that Tunisia, after several Fund-supported programs, is back on the path of external viability and domestic stability. The staff's medium-term projections show an increasing surplus in the overall external account in spite of decreasing grants and increasing imports and amortization payments. A reassuring sign of external viability and strength is provided by the staff's sensitivity analysis. In this analysis, a worsening of internal conditions owing to drought, for instance, does not significantly affect the debt-service ratio or the international reserves expressed in months of imports.

We join the staff in commending the Tunisian authorities for the timely manner in which they have discharged all Tunisia's external debt obligations, notwithstanding increasingly negative net external financial flows during the period of the adjustment program.

We welcome the ambitious program for 1992 aimed at increasing growth and further reducing macroeconomic imbalances. The scope of the 1992 program is highlighted by the fiscal deficit target. The program envisages a reduction of the deficit/GDP ratio by about one third of the 1991 projected ratio. This reduction is equivalent to a decrease of 1.3 percent of GDP in one year, compared with a reduction of about 0.1 percent of GDP a year since 1986. We welcome the authorities' intention to hold the growth of

total expenditure below projected growth levels for total revenue. We would suggest that the authorities approach structural reform with a view to reducing the size of the Government. We have some misgivings about the increase in public sector employment, mainly with respect to the perceived need to curtail government expenditures in order to achieve the deficit target.

We are pleased to see that preferential interest rates will finally be phased out by the end of the year. In spite of the actions already taken in the financial sector, the pace of structural reform in this sector should be accelerated to enhance real growth prospects and to support well-advised initiatives, such as the creation of the Ministry of International Cooperation and Foreign Investment.

We welcome the intention of the Tunisian authorities, as stated by Mr. Mirakhor, to continue close collaboration with the staff during the post-extended-arrangement period, and we encourage the authorities to persevere in their adjustment efforts. We support the proposed decisions.

Mr. Al-Tuwaijri made the following statement:

Mr. Mirakhor describes fully the record of economic adjustment and reform that the Tunisian authorities have established over the past six years. Most recently, in 1991, the authorities responded to difficult economic circumstances with timely and appropriate adjustment measures that sustained progress on the stabilization front. At the same time, the complementary process of liberalization was continued, notably in the distribution and import sectors and price liberalization.

In 1992, the Tunisian economy offers private sector agents an environment that is significantly different from that in the past in which to operate. The expanded role established for market forces over recent years, together with restrained financial policies, should provide a solid impetus to private sector activity, which will allow the economy to realize its full growth potential. The authorities' Eighth Development Plan builds upon this progress and envisages a higher sustainable rate of growth than was possible in the past. Indeed, the objectives of the Plan are ambitious, and, in order to be achieved, they will need to be matched by continued perseverance in the conduct of prudent financial policies and in the further liberalization of domestic markets.

A key element of the Development Plan is the enhancement of private sector incentives. It is essential that the liberalization of these incentives be implemented across a broad front in

order to maximize their impact on growth. For example, the benefits of harmonizing the existing investment codes to encourage investment and improve growth will depend on the enactment of other proposed complementary actions. Here, I should mention, in particular, the new labor code, which will improve flexibility and efficiency in the workplace. Also, the removal of restrictions on investment income will enhance incentives for foreign direct investment.

The medium-term fiscal framework calls for a continued commitment to budget reform and consolidation. In view of the wage bill's large share in expenditures, early progress in the proposed review of employment policy will be important for meeting the overall spending limits while accommodating an increase in investment and social sector outlays. As to social expenditures, I welcome the attention given to ensuring adequate and more effective resource flows to the critical education, health, and social safety net sectors. Clearly, adequate education opportunities are necessary for a development strategy that aims to expand employment opportunities and raise the rate of growth. The projected increase in government savings also relies on rapid growth in tax revenues. While this strong growth is based on reforms that will improve the elasticity of the tax system, the inevitable uncertainties associated with the implementation of these reforms calls for a careful monitoring of revenue developments.

The authorities' medium-term strategy aims at a careful blend of growth with adjustment. Nevertheless, the economy will remain vulnerable to exogenous shocks in the immediate future. Accordingly, an "earlier than envisaged" achievement of some of the medium-term targets, especially concerning the level of international reserves and the rate of inflation, would serve to bolster the ability of the economy to absorb and respond to adverse shocks. This, in turn, would safeguard the overall medium-term objective, namely, higher sustainable rates of growth of per capita income.

I can support the proposed decisions.

Mr. Ishikura said that, like previous speakers, he commended the authorities' adjustment efforts under the extended arrangement, which had made the satisfactory performance in 1991 possible. He welcomed the authorities' intention to consult with the Fund on policies after the expiration of the arrangement and the fact that the authorities and the staff had already agreed on benchmarks for the rest of 1992.

He was in broad agreement with the staff appraisal, Mr. Ishikura commented. On the monetary front, it was a cause for concern that, since

the middle of 1991, domestic credit as well as broad money had increased rapidly. Although recent robust economic activity might account for most of the increase, cautious financial policy was called for. The authorities should monitor monetary aggregates closely and be ready for further tightening of fiscal and monetary policies.

Preferential interest rates were expected to be eliminated by the end of 1992, Mr. Ishikura noted. However, some preferred credits had, in fact, worked well in East Asian countries in promoting key industries. Therefore, instead of abandoning the credits altogether, one option might be to restructure the preferred credit system so that it was focused on support of strategic industries such as export industries and medium-sized businesses. He would be interested in hearing the staff's views.

Mr. Barr made the following statement:

I can support the proposed decision and strongly welcome the authorities' interest in maintaining close collaboration with the Fund once this program is completed. The authorities have shown a commendable level of commitment to economic adjustment and structural reform, and impressive progress has been made under the extended arrangement. However, as Mrs. Hansen has mentioned, there remains scope for further liberalization of the economy, including further progress on reducing price controls, and there is a need to tighten domestic policies to reduce Tunisia's vulnerability to exogenous shocks.

The record cereal crop in 1991 gave the authorities an opportunity to press ahead with the reduction in consumer subsidies, which, unfortunately, was not taken. There is an urgent need to develop a detailed timetable for the complete elimination of such subsidies, which still amounted to 2.2 percent of GDP last year. Given the prospects of a reasonable 1992 harvest, I would urge the authorities not to miss this opportunity again. I can also welcome the plans to broaden the value-added tax base and improve the tax and customs administration; the anticipated fall in nontax petroleum-related revenue--19 percent in 1993--adds urgency to the need for further tax reform to strengthen the overall budgetary position.

The reduction in scope of activities eligible for preferential interest rates, although now achieved, was considerably delayed beyond its original target date of end-1991. It will be important not to delay plans to eliminate all preferential rates by end-1992. The commitment to maintaining positive real interest rates is important both to strengthen the external position and to stimulate productive investment.

As to structural measures, progress in privatization has been considerable, and I urge the authorities to continue to divest the

remaining enterprises in the public domain in order to achieve significant reductions in capital transfers to these enterprises and to improve their efficiency. Additional financial sector reforms ought to be accelerated to strengthen prudential regulations and banking supervision. The lack of progress in preparing a unified and harmonized investment code in 1991 was disappointing, given that it is so central to the authorities' medium-term growth objective, which assumes an increase in investment at an annual real rate of 10.5 percent.

I urge the authorities to move to greater nominal exchange rate stability; but such a commitment will require lower inflation and higher productivity to produce an exchange rate that will continue to support strong export growth. This stresses the importance of sound fiscal and monetary policies and further liberalization of the economy.

I strongly commend the Tunisian authorities for the admirable progress made under the extended arrangement to date and, as Mr. Bonzom has highlighted, their impeccable debt-service record. I now urge further consolidation and continuation of the adjustment process.

Mr. Esdar observed that, like other speakers, he welcomed Tunisia's steady progress toward a sustainable economic position. He was pleased to note from the staff report that further improvements had been achieved. However, as illustrated by the weaker than expected fiscal outcome in 1991 and by Tunisia's remaining vulnerability to external shocks, it was crucial that the authorities proceed further in their policies of adjustment, particularly in the fiscal and structural areas, in order to consolidate and broaden their achievements thus far.

He agreed with the staff recommendations, with possibly some modifications, Mr. Esdar remarked. In spite, or perhaps because, of the impressive overall economic performance, a more ambitious course to bring down inflation seemed to be justified, and he shared the concerns of Mrs. Hansen and Mr. Ishikura. A nominal exchange rate anchor, as proposed by Mr. Bonzom, would help to achieve further progress in that area and to increase the overall credibility of the anti-inflationary commitment.

Finally, he welcomed the intention of the Tunisian authorities to cooperate closely with the Fund after the expiration of the extended arrangement, and he supported the proposed decisions, Mr. Esdar concluded.

Mr. Posthumus said that he supported Executive Directors' comments on Tunisia's program and efforts. He would, however, suggest to the staff that, in the next consultation report to the Board, more attention be paid to macroeconomic policy and analysis. With respect to inflation performance and objectives, the report gave no indication of the staff's views on the

contribution of monetary and exchange rate policies to attaining the 4.5 percent inflation target for 1996, compared with the present inflation rate of 7.1 percent. Little comment was provided on fiscal policy. Also, there was no discussion of current account convertibility, which apparently had not been attained in the past five years.

The proposal to continue to monitor developments in the period following the extended arrangement through the use of quarterly quantitative benchmarks had been supported by many Directors, Mr. Posthumus said. He wondered whether such monitoring would entail more staff missions to Tunisia in the following year than would be the case for a country with no program.

Mr. Noonan made the following statement:

I support the proposed decisions, and, like other speakers, I also congratulate the authorities on the economy's good performance in the very difficult circumstances of 1991, on their successful adherence to the Fund-supported program, and on their effective and prudent management of debt. While good weather played an important role in 1991, the performance of the agriculture sector also owed something to previous reforms and good management.

The 1991 outturn could have been quite different if unpredictable weather conditions had been less favorable. The vulnerability of financial stability to the relative inflexibility of government spending in the face of adverse shocks to available resources would then have been made more apparent.

This vulnerability remains a source of concern for the future. Indeed, the Eighth Development Plan could add to it by projecting ambitious growth rates. Unfortunately, experience suggests that enthusiastic protagonists will urge the expansion of existing, and the development of new and often desirable, publicly financed programs, and more seriously, that ministers will enter into commitments to do so, all on the basis of growth rates that must remain hypothetical until achieved. I was therefore somewhat concerned to read in Appendix III of the staff report--on the medium-term outlook and the capacity to repay the Fund--that the fiscal projections for the period to 1996 are based on an average increase in tax revenue of 13.5 percent a year. I would have some reservations about the realism of such rapid growth in tax revenue, and about its possible adverse impact, if realized, on the achievement of the projected high growth rates, as well as its consistency with the projected high rate of growth of private sector savings--a rate of growth already questioned by Mr. Mohammed.

I would therefore point to the desirability of a more conservative revenue base, especially for the expansion and



restructuring of public services. It will be much more difficult to retrench these services, if necessary, than to expand them.

Mr. Wei made the following statement:

The Tunisian authorities are to be congratulated for their great success in adjusting their economy since 1986. Tunisia, like many other countries after the Middle East crisis, was confronted with severe difficulties in the management of its economy. Nonetheless, the authorities continue to undertake comprehensive reform policies as well as make considerable economic progress. Economic growth has averaged 4.3 percent annually in the period 1987-91, and the external account has also changed substantially. Since we are in broad agreement with the thrust of the staff appraisal, we shall make only a few remarks.

We note that the authorities are placing emphasis on the implementation of adjustment measures in the context of medium-term development strategies. The Eighth Development Plan, 1992-96, is aimed at achieving a higher, sustainable growth rate and further reducing the inflation rate, as well as strengthening the balance of payments position. In line with this strategy, the Government is undertaking a comprehensive package of structural reforms that will echo and support the policy measures to improve the budgetary position.

Aside from the policy changes to be taken in the 1992 program, we are very much impressed by the authorities' determination and commitment to improve the social conditions and living standards of the population, particularly the emphasis on alleviating poverty and providing safety nets for the more vulnerable segments of the population. While tightening expenditure controls, the Government is increasing its budgetary allocations for the education and health sectors. It is also undertaking a detailed survey of the segment of the population living in abject poverty as well as plans for providing this segment with training programs. The authorities are also actively considering a major reform of the social security system with a view to extending social security benefits to those categories of workers not covered under the previous system. In our view, these social measures under consideration are not only appropriate and necessary, but they could also mitigate any negative impact that might be created by some reforms, such as the elimination of subsidies.

While Tunisia has achieved great progress in its adjustment efforts, the authorities should continue to maintain tight financial policies as much remains to be done. The country's reserves, which were only equal to 1.9 months of imports for the

past year, are low by international standards, and the 7 percent inflation rate cannot be ignored. We also note that almost 90 percent of Tunisia's exports are bound for the industrial countries. Because of this heavy dependency, we believe that it would be not only advisable but also beneficial if Tunisia were to explore the possibility of more trading opportunities with other developing countries.

With these remarks, we support the proposed decisions.

The staff representative from the African Department explained that preferential interest rates would be eliminated so as to remove the existing distortions that favored certain activities over others. In the wider context of the elaboration of a unified investment code, a strategy would be elaborated for targeting the benefits that would be needed to promote investment and development in Tunisia.

The Tunisian authorities would agree that the staff had discussed macroeconomic policy with them extensively, the staff representative commented. Initially, discussions could not be concluded because of differences in the assessment of macroeconomic policy, and a further review of macroeconomic policies under the Eighth Development Plan had had to be undertaken. The staff report included on pages 4 and 5 a short summary presenting the highlights of several days' discussion and in Appendix III, for the first time, a detailed analysis of the authorities' medium-term budgetary projections that could constitute a benchmark for measuring the progress being made. Nonetheless, the comments of Mr. Posthumus would be considered in the staff's further discussions with the Tunisian authorities.

On fiscal revenue, over the past few years there had been a move away from the taxation of imports, as well as some not fully successful attempts to move to the taxation of domestic production, the staff representative noted. The tax reforms that had been put in place were being reassessed to see how they could be improved. The objective was to rely less on customs duties, which had a tendency to promote inefficiency, and more on general income tax and value-added tax.

The authorities were looking at trading opportunities with other developing countries as well as the opening up of the Tunisian economy, the staff representative remarked. The liberalization under way was encouraging an increasing number of entrepreneurs to look outward at the possibilities for exporting the increased volume of industrial goods that Tunisia would be producing in the following few years.

With respect to monitoring, no reviews of the progress made within the year would be undertaken, the staff representative from the African Department said. Toward the end of the year, when preparing the next budget, the authorities would consult closely with the staff--as had been done traditionally--on budgetary and monetary policies and other elements of

the 1993 program. Those discussions would be reported to the Board in the context of the next Article IV consultation.

The staff representative from the Policy Development and Review Department remarked that the use of preferential, concessional interest rates and government-administered sectoral credit allocations had weakened banking systems and financial institutions in a number of countries. The staff, however, would not rule out the merit of some form of direct help for key sectors that might benefit from such incentives, but to do so through special interest rates and sectoral credit allocations would not promote the banking system itself.

The bunching of purchases in the present case was unusual, the staff representative commented. Because the staff believed that the program was on track, it had not proposed a further lengthening of the arrangement to cover disbursement of the last purchase and had maintained end-May 1992 as the final test date.

The issue raised by Mrs. Hansen about the sequencing of trade and price liberalization had been considered by the staff, and it felt that, in a situation where domestic enterprises had an oligopolistic or monopolistic position, one would want trade liberalization to proceed quickly, the staff representative from the Policy Development and Review Department observed. But in reality, it seemed feasible to proceed with trade and price liberalization in a phased manner.

Mrs. Hansen said that the explanation for the bunching of purchases was clear. Her question had arisen from the fact that the only reference in the report to one purchase had been in a footnote; a close reading had been required to determine what the country would be able to draw from the Fund.

Mr. Mirakhor remarked that the proposed monitoring would not require travel by the Fund staff to Tunisia. Monitoring could also be accomplished by having the authorities meet with the staff for consultations in the Fund.

As to the content of the report, he recalled that the Board had asked the staff to keep the papers short, Mr. Mirakhor said. For the present review discussion, it was not necessary to discuss every topic considered important by each Director. Nevertheless, the authorities' letter of intent described macroeconomic policy in detail; if questions remained, he would be pleased to take them up on a bilateral basis.

He thanked the Executive Board for its support of Tunisia's efforts under the extended arrangement, Mr. Mirakhor continued. The year 1992 had been an exceptional one for his constituency, with the graduation of Ghana, Morocco, and Tunisia shortly, following intensive collaboration with the Fund, which he hoped would continue in the future. Ghana's close collaboration with the Fund was continuing even after its graduation, and the Tunisian authorities had already committed themselves to continued

cooperation. The efforts of Fund management and staff in support of those countries and other members of his constituency were appreciated.

The Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff appraisal. They welcomed Tunisia's continuing good performance under its adjustment program, supported by an extended arrangement with the Fund which had been extended to a fourth year. Directors pointed to the progress made in recent years in the liberalization of prices and trade, the restructuring of the financial system, and the reform of the tax system, as well as the privatization of a number of public enterprises and the restructuring of others. They noted that these structural adjustment efforts, supported by prudent demand-management and debt policies, had contributed to a revival of economic activity, a reduction of inflationary pressures, and a strengthening of the external position.

Directors agreed with the emphasis placed by the authorities on improving the efficiency of investment while enhancing private sector savings and reducing government absorption in order to achieve a sustainable growth rate and a further strengthening of the balance of payments position. Accordingly, they stressed that the effective implementation of the 1992 program was essential to the attainment of these objectives.

Directors welcomed the further steps recently taken in the areas of trade liberalization and financial sector reform. They urged the authorities to continue the liberalization process, and in particular, they emphasized the importance of the authorities' undertaking to fully liberalize producer prices of manufactured goods, increase the share of liberalized distribution margins, and eliminate preferential interest rates in 1992. Several Directors considered that the adoption of a revised labor code introducing greater flexibility in the labor market and the reform and unification of the investment codes would also be important steps in the right direction. Directors encouraged the authorities to ease exchange restrictions further in the context of their efforts to establish currency convertibility for current account transactions.

Directors stressed that progress in fiscal adjustment would need to be monitored carefully to avoid slippages and ensure that the medium-term targets were achieved. They encouraged the authorities to further strengthen the tax and customs administration and banking supervision, broaden the value-added tax base, and restrain the growth of the wage bill through limits on additional employment and pursuit of a cautious incomes policy. While noting the progress already achieved, Directors also

stressed the need to accelerate the reform of public enterprises so as to reduce their reliance on budgetary support and improve the savings performance of the nongovernment sector.

In endorsing Tunisia's prudent monetary policy, Directors pointed out that the positive real interest rates would help to mobilize financial savings and channel them into productive investments. They emphasized the importance of restrained financial policies and continued structural reforms in ensuring external competitiveness. Some Directors cautioned that the authorities should monitor monetary aggregates closely with a view to reducing the rate of inflation.

Directors voiced support for the increased budgetary allocations for the key social sectors of education and health and the ongoing work to reform the social security system. They observed that the improved protection of the most vulnerable segments of the population was likely to enhance the success of the ongoing adjustment efforts. In this regard, however, the need for improved targeting and direct income support was noted.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Tunisia's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1992 Article XIV consultation with Tunisia, in the light of the 1992 Article IV consultation with Tunisia conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Tunisia maintains restrictions on the making of payments and transfers for current international transactions as described in EBS/92/93 in accordance with Article XIV, except that the multiple currency practice arising from the operations of the former exchange rate risk guarantee fund is subject to approval of the Fund under Article VIII, Sections 2 and 3.

Decision No. 10065-(92/82), adopted  
June 29, 1992

Review Under Extended Arrangement

1. Tunisia has consulted with the Fund in accordance with paragraph 4(c) of the extended arrangement for Tunisia (EBS/88/119, Sup. 1, 7/28/88, as amended by Executive Board Decisions No. 9429-(90/75), 5/14/90, and No. 9775-(91/94), 7/17/91) and paragraph 2 of the letter dated June 18, 1991 from the Minister of Finance, the Minister of Planning and Regional Development, and the Governor of the Central Bank of Tunisia, in order to review the implementation of the measures described in that letter and its attached table, and to establish performance criteria for the remaining period of the extended arrangement.

2. The letter, with annexed tables, dated May 26, 1992 from the Minister of Finance, the Minister of Planning and Regional Development, and the Governor of the Central Bank of Tunisia shall be attached to the extended arrangement, and the letters dated June 16, 1988, March 23, 1989, December 1, 1989, April 12, 1990, October 10, 1990, March 18, 1991, and June 18, 1991, together with their respective annexes and tables, shall be read as supplemented by the letter dated May 26, 1992 and annexed tables.

3. Accordingly:

(a) Paragraph 2 of the extended arrangement for Tunisia shall be partially amended to read:

"2. Purchases under this extended arrangement shall not, without the consent of the Fund, exceed...the equivalent of SDR 172.75 million until July 10, 1992."

(b) Paragraph 4(a) of the extended arrangement for Tunisia shall comprise a reference to Table 2 annexed to the letter dated May 26, 1992.

4. The Fund decides that the review contemplated in paragraph 4(c) of the extended arrangement for Tunisia is completed and that, notwithstanding paragraph 4(a) of the same, Tunisia may proceed to make purchases under the arrangement that shall not exceed the equivalent of SDR 172.75 million until July 10, 1992.

Decision No. 10066-(92/82). adopted  
June 29, 1992

4. REPUBLIC OF MACEDONIA - APPLICATION FOR MEMBERSHIP

The Managing Director informed the Board that an application for membership from the Republic of Macedonia had been received in the Fund on

June 29, 1992 (EBD/92/136, 7/2/92). He noted that the staff would be preparing a background note on the international status of the applicant.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/92/81 (6/26/92) and EBM/92/82 (6/29/92).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/172 through 91/174 are approved.

APPROVED: March 12, 1993

LEO VAN HOUTVEN  
Secretary