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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/38

10:15 a.m., March 22, 1993

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
T. C. Dawson	J. M. Abbott, Temporary
	V. Kural, Temporary
E. A. Evans	A. M. Tetangco, Jr.
I. Fridriksson	
H. Fukui	K. Nakagawa, Temporary
	L. E. N. Fernando
J. E. Ismael	K.-T. Hetrakul
D. Kaeser	K. Link
	J. C. Jaramillo
	A. V. Mozhin
G. Lanciotti	
	I. Martel
	H. Dognin, Temporary
	J. M. Burdiel, Temporary
	O. Kabbaj
	H. Golriz, Temporary
L. J. Mwananshiku	B. S. Dlamini
D. Peretz	J. Dorrington
G. A. Posthumus	O. Havrylyshyn
C. V. Santos	
	W. Laux, Temporary
A. S. Shaalan	S. S. Farid, Temporary
D. E. Smee	G. Lindsay-Nanton, Temporary
Zhang M.	Wei B.
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
A. Mountford, Acting Secretary
S. L. Yeager, Assistant
S. W. Tenney, Assistant

<u>Also Present</u>
IBRD: M. Durdag, East Asia and Pacific Regional Office; K. Yurukoglu, Europe and Central Asia Regional Office. African Department: J. A. Clément. European I Department: M. Russo, Director; M. C. Deppler, T. Shikado. European II Department: E. Brau, Deputy Director; I. Ceolho, M. de Zamaroczy, E. Gurgen, E. M. Ucer. External Relations Department: M. R. Kelly, Deputy Director; G. Hacche. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; P. L. Francotte. Monetary and Exchange Affairs Department: P. Stella. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; A. Basu, M. E. Edo, A. K. McGuirk, D. O. Robinson. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, R. A. Feldman. Secretary's Department: J. W. Lang, Deputy Secretary; B. R. Hughes, A. Jbili, A. Mountford. Statistics Department: B. Gurgen. Treasurer's Department: D. Williams, Treasurer. Western Hemisphere Department: J. M. Landell-Mills. Advisors to Executive Directors: M. B. Chatah, R. F. Cippa, S. K. Fayyad, B. R. Fuleihan, A. R. Ismael, P. A. Merino, J.-C. Obame, F. A. Quirós, A. Raza, B. Szombati, J. W. van der Kaaij, Yang X. Assistants to Executive Directors: D. A. Barr, M. Blome, R. Ferrillo, A. Giustiniani, M. E. Hansen, K. M. Heinonen, E. Kotova, A. M. Koulizade, K. J. Langdon, G. J. Matthews, S. C. McDougall, F. Moss, J. A. K. Munthali, S. del C. Olgiati, S. K. R. Regmi, N. Shimizu, T. P. Thomas.

1. INTERIM COMMITTEE - PROVISIONAL AGENDA

The Executive Directors considered a draft provisional agenda for the Fortieth Meeting of the Interim Committee (EBD/93/44, 3/19/93).

The Chairman remarked that the Interim Committee would be meeting at a critical moment in the economic cycle and history, and the Board could help give the Committee's discussions a precise and clear orientation so that the deliberations would, he hoped, lead to increased confidence in the world.

Mr. Evans said that Item 2 of the draft provisional agenda--prospects and policies for strong noninflationary growth of industrial and developing countries--was properly the main focus of the Interim Committee meeting, and he was pleased to see that in the accompanying notes to the agenda, the procedures recommended for addressing that item were along the lines discussed by the Executive Board at its recent retreat. The procedures, which should lead to a more productive discussion, stopped short of suggesting that members confine their interventions to two minutes. He believed that proposing such a limit from the outset would be more successful and would minimize moral hazard problems.

On Items 3 and 4--adjustment and financing in low-income developing countries, including the Fund's role through the ESAF, and further strengthening Fund surveillance--it was appropriate that the Managing Director report to the Committee on the Board's work on those topics, and he presumed that, consistent with the procedure being adopted for Item 2, the respective reports would be circulated in advance, Mr. Evans continued. On that basis, perhaps discussion of those items should not be encouraged by inviting lead speakers; instead, the floor could be left open with no expectation of concerted discussion.

As to the items for the afternoon session, Item 5--economic stabilization and transformation in the economies in transition in Eastern Europe and the former states of the Soviet Union--was clearly appropriate, and discussion, no doubt, would focus on Russia, Mr. Evans observed. However, as he had done in the past, he would again ask that discussion of economies in transition not be limited to Eastern Europe and the states of the former Soviet Union. His comments on that point had been accepted in the Board on previous occasions, and thus there had been scope for Directors to consider transitional issues for economies such as Mongolia, Vietnam, Cambodia, and other members in Asia. He believed that the matter should be kept open, geographically, in the Interim Committee as well and, more important, in the treatment of the issue within the Fund generally.

Item 6--further review of the question of allocations of SDRs--was not a new issue, but the question had not been discussed by the Board since the previous Interim Committee meeting, Mr. Evans remarked. It might be true that subsequent developments warranted its inclusion in the provisional agenda without further Board discussion, but he doubted that Interim Committee consideration would lead to a fruitful outcome at the present time. On that basis, and in view of the other important issues before the Committee, he suggested that the item be left for a later date.

No mention was made regarding arrangements for lunch and dinner for Committee Members, Mr. Evans observed. He presumed that as the proceedings would be condensed, there would be no dinner, but it might be desirable to give some thought to what might occur over lunch. In that regard, he considered that a continuation of the discussion on Item 2, particularly policy aspects, would be most appropriate.

Mr. Dawson stated that he generally agreed with the points made by Mr. Evans. At their luncheon, in addition to continuing their exchange of views on Item 2, Committee Members might also wish to discuss further Item 4--further strengthening Fund surveillance. He had initially thought that perhaps both Items 3 and 4 could be subjects for discussion at lunch, as that had been the format in the past. He was, however, open-minded on the matter. If the consensus was that the industrial countries should receive heightened emphasis, particularly with respect to surveillance issues, it might be appropriate to discuss Item 4 at lunch.

The morning session was scheduled to begin at 9:30 in the morning, Mr. Dawson observed. He understood that the Group of Ten would, as usual, be meeting earlier that morning. In current circumstances, their agenda would be less perfunctory in that the Group would also be reviewing the reports that it had commissioned the previous fall on exchange market activities and related matters. To allow Ministers of the Group of Ten sufficient time to conclude their review and be present at the beginning of the Interim Committee's morning session, he would suggest that the morning session be convened somewhat later, say, at 10 o'clock.

Like Mr. Evans, he would appreciate some clarification regarding Item 6, Mr. Dawson remarked. While it was true that the Board had been asked to keep the issue of SDR allocations under constant review, it had not discussed the matter for about a year or so.

The Chairman recalled that the Board had been asked by the Interim Committee to keep the matter of an SDR allocation under review, and in the coming days, he expected to be in touch with Executive Directors to see how their views on the matter were evolving. If his conversations with Directors suggested that it would be helpful to discuss the issue further, it might be brought to the Board prior to the Interim Committee meeting. In the circumstances, he would suggest taking a flexible approach at the current stage.

Mr. Fukui remarked that he agreed with the proposed agenda, but like Mr. Evans, he would like to see Item 5 broadened to include some Asian economies in transition, such as Viet Nam, Cambodia, and Mongolia. The item might be reformulated to include economies in transition in general.

As to Item 6, he understood that the Managing Director intended to report on the matter in a neutral way so as to keep up the momentum of the discussion, Mr. Fukui continued. While the matter was still under Board consideration, in his view, Directors had not yet come close to any sort of conclusion. Moreover, little time remained to discuss the issue before the Interim Committee meeting. Thus, even if the Board took up the matter of an SDR allocation, he did not think that it would further the issue greatly. In his view, whether to include the matter on the agenda should be kept under review.

He would appreciate some elaboration on the new procedures for the conduct of the meetings, Mr. Fukui commented. For example, if Members circulated their statements in advance, would they be expected to repeat basic points in their interventions? Or should they emphasize only controversial points? Did the Chairman expect that the new procedures would allow more time for a spontaneous and substantive discussion? Similarly, on the lead speaker system, he wondered how many lead speakers there would be and whether they would be nominated or were expected to volunteer. Also, would other speakers be expected to make some comment?

The Chairman observed that the suggestion had been made that speakers circulate the text of their full intervention beforehand and focus their oral statement on basic points so that the meeting would be more effective and the discussion more interactive. The innovation did not seek to shorten the deliberations, but rather to generate a livelier, more candid debate so that the Committee's meetings better served their purpose. At the same time, to facilitate debate and assure that all speakers had an opportunity to fully articulate their views, provision would be made to circulate their full statements in advance of the meeting.

The Secretary, commenting on the lead speaker system, observed that the system had been implemented in a flexible manner. On occasion, the Chairman had approached certain Members to see whether they wished to volunteer to be a lead speaker, and Executive Directors had also been active in that regard. The Chairman wished to respect very much the initiative of individual Members. For the forthcoming meeting, he would very much welcome Executive Directors' informing the Secretary whether a Member wished to be a lead speaker on a particular item. That information would then be brought to the attention of the Chairman, who would seek to draw up a list of lead speakers for the various items that would be representative of the entire Committee.

With respect to the revised procedure for discussion of the world economic outlook--Item 2, the Chairman might wish to invite a number of colleagues to be lead speakers so as to help to focus the discussion, particularly in terms of the strategy for stronger growth of the world economy, the Secretary remarked. He would expect to see lead speakers for Item 2 and 5, at a minimum. For the other items, the Chairman was in the hands of Committee Members. After Members had submitted their full statements for circulation, they might wish to take up to two minutes to present orally the key issues, or they might prefer to have lead speakers, followed by a number of shorter interventions on the part of others. It would be helpful if Directors could advise him, on behalf of their Member, what approach was preferred. He could then inform all concerned regarding the lead speakers for the various items shortly before the Interim Committee meeting.

Mr. Peretz said that if the Chairman of the Group of Ten anticipated that the Group might need additional time to complete its agenda, he would associate himself with the request that the Interim Committee's morning session start at 10 o'clock, on an exceptional basis.

On the circulation of statements and time limits for interventions, he would suggest three minutes rather than two, Mr. Peretz remarked. It was difficult to say anything at all in two minutes. He agreed with Mr. Evans that written guidance should be given to that effect at the outset. He hoped that the lead speakers, the Managing Director, and the Committee Chairman would also circulate their statements in advance.

He had some doubts about the idea of having lead speakers on Item 2, Mr. Peretz continued. He thought that all Committee Members would wish to speak on the world economic outlook. He wondered, however, about having a separate discussion of Items 2, 3, and 4. He suspected that a number of Ministers would want to deal with all three issues in their advance statements. He also questioned whether discussion of Items 2 and 4, which were closely related, could be separated. He favored the idea of continuing the discussion of Items 3 and 4 at lunch. He wondered whether Item 6 might also be a subject for lunchtime discussion. In the circumstances, there might be a case for withholding that item from the agenda until it was clear that there was something to discuss. If necessary, it could be added as a last-minute item.

He would appreciate confirmation of his understanding that no dinner was being planned for Ministers, Mr. Peretz stated. If that was the case, he would suggest holding the final plenary, at which Ministers adopted the communiqué, later in the afternoon or in the evening of April 30, rather than the following morning, as was customary.

Mr. Posthumus said that he agreed with Mr. Peretz regarding the timing of the morning plenary and the meeting of the Group of Ten. He understood that the main item on the agenda of the Group was the capital markets report, and he hoped that other members of the Group would be informed in a timely fashion if any other reports or decisions were expected to be placed on the agenda.

On Item 2, he found the word "strong" unnecessary, Mr. Posthumus continued. If used too often, the word lost its meaning; and it did not fit in the current context. He would prefer "prospects and policies for non-inflationary growth...." In addition, on Item 5, it was not clear what was intended by "economies in transition." China, for example, was also a country in transition. He thought that the focus of the item was on former centrally planned economies that were moving to market economies, and that was a clearly identifiable group.

He supported Mr. Peretz's suggestion regarding Item 6, Mr. Posthumus remarked. The Managing Director might have created some expectations in that regard during his March 4 speech in Brussels on allocations of SDRs. If the item was then included on the agenda--which was likely to be leaked--those expectations would be strengthened. As he did not think that authorities were as yet prepared to hold that discussion, he would prefer to keep the item off the agenda; it could instead be kept in the back of Directors' minds in the coming weeks.

Mr. Dawson said that because the Chairman of the Group of Ten expected that the discussion of the report on capital markets would be prolonged, he had requested delaying the Committee's morning plenary until 10 o'clock. There was no hidden agenda in that request.

The Chairman remarked that even with some experience in dealing with the media, one sometimes encountered surprises. That was the case in Brussels, where he had used the conventional language he had used for some time in commenting on SDR allocations. Moreover, as he was speaking in Brussels, it was normal to pay tribute to the ideas that Mr. Maystadt supported. No reports on his speech appeared until two or three days later, when it was reported as a new initiative.

There was, in fact, no new initiative; he was, however, obliged to ascertain Directors' evolving views on an SDR allocation before the forthcoming Interim Committee meeting, the Chairman stated. Moreover, it was important, in his view, to keep open the possibility for Ministers to revisit the issue if they so wished. That could be done by including it as a possible agenda item, or as a point for discussion at lunch. He maintained an open mind in that regard.

Mr. Fernando observed that as reports on the Brussels speech might have mistakenly strengthened expectations regarding an SDR allocation, the exclusion of the issue from the agenda might also be misinterpreted.

Mr. Fukui remarked that as the intention was to keep up the momentum of discussions on an SDR allocation, he could support Mr. Peretz's suggestion to withhold adding the item to the agenda until the last minute, or including it as an issue for discussion at lunch, as a practical solution.

Mr. Laux stated that, like Mr. Dawson, he was puzzled by the inclusion of Item 6, as the Board had not discussed the issue and it was not on the tentative schedule of Executive Board meetings. He understood its inclusion as a precaution in the event that developments warranted further discussion, but he would prefer the flexible approach proposed by Mr. Peretz--namely, to drop the item if there was nothing new to discuss, or to put it on the agenda as a last-minute item if new developments suggested that a discussion might be interesting and fruitful.

The Chairman said that he would prefer not to surprise Ministers and Governors with last-minute additions to the agenda. He would prefer to note the possible inclusion of the issue in some way or to indicate that it would be a subject for discussion at lunch.

Mr. Posthumus remarked that the Managing Director's usual consultation with members to find out whether there was progress to report would be one way to deal with the issue. In the Brussels speech, however, that exercise had been linked to support for Russia, which was the new element picked up in press reports. In light of those reports, if the question of SDR allocations was kept on the agenda, it should be described as a regular annual review. As currently proposed, its inclusion would feed expectations generated by reports on the Brussels speech--something that should be avoided.

Mr. Shaalan suggested, as a possible compromise, that the agenda might indicate a "possible further review."

Mr. Fridriksson said that he generally agreed with Mr. Evans's remarks at the outset of the discussion. He favored the use of lead speakers to the extent possible. While he realized that it might be difficult to use the lead speaker system for the discussion on the world economic outlook, he would nevertheless be willing to see it attempted even there. Otherwise, he would suggest strict guidelines on the length of interventions, so as to allow room for spontaneous discussion following Members' introductory remarks. But that also required the early circulation of statements. If there were to be a lead speaker system or a restricted number of participants, he would emphasize the importance of having a broad representation of the membership in terms of regions and stages of economic development.

As to convening the morning session at 10 o'clock, he would suggest instead that the Group of Ten start its meeting one-half hour earlier rather than delay the Interim Committee's plenary, Mr. Fridriksson commented.

He was somewhat surprised to see the inclusion of the SDR issue on the agenda, and he would prefer a more subdued reference to it, Mr. Fridriksson continued. The lagged response of the press to the Managing Director's Brussels speech had already alerted many Ministers and officials to the fact that the issue might surface in the not too distant future. Nevertheless, he would prefer to see it given less prominence, perhaps by including it instead in the notes as an issue for discussion over lunch.

He supported the suggestion that Item 5 be changed to refer to formerly centrally planned economies, Mr. Fridriksson commented. He would also strongly endorse continued efforts to keep the communiqué as short as possible.

Mr. Lanciotti said that he shared the concerns of Mr. Dawson about the timing of the morning session. He wondered whether it would be possible to accommodate the request of the Group of Ten so that Ministers would have sufficient time to discuss the report on capital markets.

Mr. Peretz remarked that he supported Mr. Fridriksson's proposal to include the item on SDRs in the notes on issues for discussion over lunch. That compromise appeared to meet a number of the concerns that had been expressed about raising expectations.

Mr. Kaeser said that he could associate himself with Mr. Peretz's remarks, including those on the SDR issue. As to the organization of the meeting, he considered that the new procedures should not result in silencing speakers, or sequester Members of the Interim Committee. If there were lead speakers, they should be broadly representative of the membership. It would also be necessary, if there was to be a lively discussion, to provide enough interpretation support.

The Chairman commented that the interpretation support would, as usual, be the broadest possible. He was very much open to using lead speakers, but for Item 2, on the current state of the world economy, it was important that all Members be encouraged to participate. No one should feel restricted from contributing to a lively discussion, but everyone should be restricted on the length of their prepared interventions.

Mrs. Martel said that she agreed with the proposed agenda and with the proposals aiming at streamlining the discussions, notably the two- or three-minute limit on interventions. She had no problems with beginning the morning session at 10 o'clock.

As regards Item 3, she welcomed the proposal to have a report by the Managing Director focusing the attention of the Committee on the difficult circumstances of low-income developing countries, and as had been stressed by most Directors during the recent review of the enhanced structural adjustment facility, on the positive role played by the Fund through that facility, Mrs. Martel remarked. The report could also include considerations on the preparatory work being undertaken with a view to fulfilling the need for continued Fund involvement in concessional support of that category of members beyond November 1993. She also welcomed the opportunity that would be given to Members of the Committee to exchange views on the question of SDR allocations, and she favored keeping that item on the agenda.

Mr. Smee commented that he was pleased to see how seriously the ideas put forward during the Board's retreat in February were being taken, particularly with respect to trying to liven up the discussion and the organization of the Interim Committee meeting. Making the meeting more interactive and more interesting would involve a process of trial and error, and further changes in the conduct of the meetings could be made as experience was gained until meetings became the kind of meetings that all Directors would like to see.

He generally agreed with Mr. Evans's remarks at the outset of the discussion, Mr. Smee continued. He would particularly agree that interventions on the world economic outlook should be kept to two minutes, rather than three or four; the time limit was usually exceeded in any event. That limit should be specifically mentioned in the draft agenda.

With respect to lead speakers for the discussion on the world economic outlook, he had understood that everyone might intervene for two minutes or so, and thereafter the discussion would be opened up to allow for a truly interactive exchange of views--elaborations and reactions--in the light of those interventions. He therefore did not think that the lead speaker system would be useful for that item, which, as the Chairman had remarked, would be the heart of the Committee's deliberations.

He also agreed with Mr. Evans's comments on the SDR, Mr. Smee stated. He would prefer to wait and see how the issue developed, and to add it to the agenda later, if necessary. He frankly did not see much need for any further discussion of the matter, and he agreed with Mr. Posthumus that the expectations that had been raised should not be encouraged unless and until the Board had thoroughly discussed the issue.

He supported Mr. Dawson's request for convening the morning plenary at 10 o'clock so as to give Group of Ten Ministers more time to discuss the paper on capital markets, Mr. Smee concluded.

Mr. Al-Jasser said that he agreed with Mr. Smee's remarks, particularly with respect to the conduct of the meetings. He had also understood that there would not be lead speakers for the morning session, but rather there would be brief statements, after which the floor would be open for follow-up comments and a broad participation in the discussion. For the afternoon session, the lead speaker system would be most helpful, although on Item 5, he agreed with the points raised by Mr. Evans and other speakers.

He had also been surprised to see the inclusion of Item 6, which gave the impression that there had been or would be a Board discussion on the SDR on which to report, which was not the case, Mr. Al-Jasser commented. To avoid raising unfounded expectations, he agreed with those speakers who had recommended that the matter not be placed on the agenda. If, however, the consensus supported its inclusion, he would prefer to see it placed in the notes as an issue on which the Managing Director would report during the Committee's luncheon. If developments indicated that the matter warranted Board discussion before the Interim Committee meeting, and a report then had to be presented to the Governors, he did not think they would object to adding it as an agenda item at a later date.

Mr. Jaramillo stated that he wished to associate himself with Mr. Smee's comments on the use of lead speakers for the discussion on the world economic outlook, and with those who wished to see the SDR topic on the agenda.

Mr. Ismael recalled that Mr. Dawson had proposed that the start of the Interim Committee's morning session be set at 10 o'clock rather than at 9:30 o'clock. In that regard, he wished to make an appeal. At the 1991 Annual Meetings in Bangkok, when the meeting of the Interim Committee convened, the Group of Ten had not finished its deliberations, and the absence of its Ministers at the Committee's plenary session created the unfortunate impression that the Interim Committee, and the rest of the world, was not important. He would therefore make the appeal that if the Group of Ten met prior to the Interim Committee meeting and it was agreed that the Interim Committee would convene at 10:00 o'clock, that the Group complete its meeting in time for Ministers to be present at the start of the Interim Committee's morning session.

The Chairman said that he very much agreed with Mr. Ismael's last point. He would indeed urge all interested parties to have in mind the importance of avoiding such timing conflicts.

Mr. Fukui remarked that while he did not wish to discourage efforts to achieve an interactive debate, he was not sure, from a practical standpoint, that Members could be expected to make spontaneous interventions. The words used were important, and that entailed prepared remarks. In that sense, the new approach should be carried out on a trial-and-error basis, and with flexibility; if problems developed, the Board should again review the organization of the meetings. As to the logistics, as there would be no dinner, he wondered when the drafting session for the press communiqué would be held.

Mr. Fernando said that on Item 5, he saw merit in increasing the geographical coverage to include the countries mentioned by Mr. Evans, if the documentation envisaged for the item could accommodate a broader approach. On the SDR, it should be included as an item on the agenda, preferably in the notes.

Mr. Peretz stated that Mr. Ismael's comments were well taken. In his experience, it was exceptional that the Group of Ten had such an important report to consider.

He hoped that the footnotes would allow for the possibility that circulated statements would cover more than Item 2, Mr. Peretz remarked. A number of Ministers might wish to address several items in a single statement for circulation, which would actually help facilitate the proceedings. That would be a matter of individual choice. At the moment, the footnote mentioned circulated statements only for Item 2.

The Chairman said that he would convey that constructive suggestion to the Chairman of the Interim Committee.

Mr. Dawson stated that it was precisely because the Group of Ten wanted to avoid repeating the experience of the Group of Seven in Bangkok that the

Chairman of the Group of Ten had made his request regarding the starting time of the Interim Committee meeting.

Mr. Posthumus said that he agreed with Mr. Ismael. Such timing conflicts were in fact more general, and in that regard he recalled that a meeting of European Ministers of Finance had been called during an Interim Committee meeting. On another matter, he understood that for Items 3 and 4, Ministers would not prepare statements for distribution in advance, but would offer remarks in response to a report by the Managing Director.

The Chairman remarked that he intended to circulate his reports on Items 3 and 4 in advance, and offer only a few comments at the discussion. Committee members would, as Mr. Posthumus understood, then be asked to offer their comments on those reports.

Mr. Al-Jasser said that he understood that the Managing Director's reports would be circulated as usual, and Governors could include their views on Items 3 and 4, in addition to Item 2, in their circulated statements.

Mr. Evans remarked that he agreed with Mr. Ismael regarding the request of the Group of Ten. He would be interested to have more information on the Group's meeting. He wondered in particular whether the paper to be considered by the Group would be made available to the Interim Committee.

The Chairman recalled that at the recent meeting of the Group of Ten Deputies in Washington, they had discussed their report on the September exchange market crisis. They had not concluded their work and would meet again with a view to producing a report for discussion by Ministers prior to the Interim Committee meeting. In that light, he expected that the agenda of the Group of Ten Ministers would include the report on the September crisis, points on the agenda for the Interim Committee, the election of a new Chairman, other business, and their press communiqué.

Mr. Dawson said that he believed the Chairman had correctly described the Group's agenda. He also had the impression that the report on capital markets would be published, but it was not clear when. The study had been noted in the last Interim Committee communiqué and in that sense, it had been encouraged and welcomed by Committee Members.

Mr. Kaeser remarked that he would be interested to know whether it was envisaged to hold a meeting on the morning of May 1 to finalize the press communiqué, or whether that might be accomplished at the end of the afternoon session.

The Secretary observed that Directors had agreed, on an exceptional basis, that the Interim Committee's morning session would start at 10 o'clock. In that context, he had noted Mr. Ismael's appeal.

With regard to Item 2, it was agreed that Members would submit in advance the full text of their statements for circulation to all participants. That practice would also be followed by the Managing Director with respect to his statement. There was support for the idea that Members should feel free to include in their written submission not only their comments on Item 2, but also on Items 3 and 4; any Member who wished to go even further should also feel free to do so. In the discussion, the Chairman would invite Members to limit their oral remarks on Item 2 to two or three minutes so as to allow time for a more interactive discussion of the views that had been presented. During their intervention, Members could also comment on Items 3 and 4, it being understood that those items would be further discussed over lunch. Whether Item 6 remained on the agenda, and where it appeared, would be a subject of the Managing Director's conversation with the Chairman.

In the afternoon, the Committee would take up Item 5, the Secretary continued. As to the formulation of Item 5, varying views had been expressed. Some Directors supported deleting the words "in Eastern Europe and the FSU Countries," while other speakers preferred to specify "formerly centrally planned economies." Most Directors appeared to favor broadening the item, namely, to treat "economic stabilization and transformation in the economies in transition."

The question of dinner arrangements would be a subject of the Managing Director's discussion with Chairman Solchaga, who would indicate his intentions when he communicated with Committee Members, the Secretary stated. If there was no dinner, the idea would be to complete the proceedings in one day. As the press communiqué needed to receive the blessing of the Ministers--and it remained the firm intention of the Chairman to have a short communiqué that would not require substantive discussion by Ministers--it might be possible, as on recent occasions, to achieve a broad consensus on the language of the draft communiqué through an informal meeting of interested officials. Under that informal approach, following the morning session, the staff would circulate draft paragraphs of the communiqué covering the agenda items that had been considered in the morning, so that an informal meeting of interested officials could start around 2:30 p.m. Further paragraphs covering the remaining agenda items would be made available later in the afternoon, so that the informal meeting should be able to complete its work in time for Ministers to review the draft communiqué and to finalize it before the close of the afternoon plenary. In the customary fashion, the Chairman and the Managing Director would hold their joint press conference soon thereafter, that same evening.

The Chairman remarked that the approach the Secretary had outlined would he hoped, be an improvement in the conduct of the meetings. He would speak with Chairman Solchaga in the course of the day to convey Director's views on the draft agenda. He would faithfully report all the suggestions that had been made. Chairman Solchaga would then draw his conclusions and communicate with Members of the Committee. That communication would, in the usual fashion, be circulated to Directors as a Committee document, and would indicate how the Chairman intended to organize the meeting with the collaboration of his colleagues.

Mr. Peretz commented that on Item 5, he had some difficulty with dropping the reference to Eastern Europe and the states of the former Soviet Union in favor of "economies in transition." That phrase was a term of art, and it was not obvious to those outside the Fund what countries were involved. He would prefer to keep the item as it was, or he could support "previously centrally planned economies."

Mr. Evans observed that as the Committee was likely to be talking about Russia, that could be plainly stated. If Russia was not mentioned, there was no need to restrict the discussion to "Eastern Europe and the states of the former Soviet Union." His concern was not so much with the discussion on economies in transition in the Committee as it was with the Fund's work on issues related to those economies. The staff in the Asian Department had been working on those issues long before developments in Europe shifted attention to that area, and there was a real need to keep the work that was being done in respect of economies in transition in Asia coordinated with that being done in Europe.

Mr. Fukui said that he could go along with "economic stabilization and transformation in the former centrally planned economies."

The Chairman remarked that he would suggest to the Chairman of the Interim Committee that Item 5 be reformulated to read "economic stabilization and transformation in the former centrally planned economies."

The Executive Board took the following decision:

> The Executive Board agrees to transmit the provisional agenda for the Fortieth Meeting of the Interim Committee set out in EBD/93/44 (3/19/93), as amended in the light of the discussion, to the Chairman of the Interim Committee.

Adopted March 22, 1993

2. AZERBAIJAN REPUBLIC - 1992 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1992 Article IV consultation with Azerbaijan (SM/93/33, 2/9/93; Cor.1, 3/4/93; and Sup. 1, 3/16/93). They also had before them a background paper on recent economic developments in Azerbaijan (SM/93/51, 3/5/93).

Mr. Kaeser made the following statement:

> Azerbaijan has great economic potential. Its agricultural land is among the most fertile in the former Soviet Union (FSU), and its endowment of mineral resources, notably crude oil and gas

reserves, is considerable. Industry is already relatively well developed, although it remains too one-sector oriented. An important effort aimed at modernizing and diversifying the industrial base is necessary in order to fully grasp the potential benefits that the country can offer.

Like other FSU economies, Azerbaijan was severely hit by the breakdown of the central command system, the weakening of traditionally very strong trade links with the other republics, and the uncertainties related to the ruble zone as a whole. Moreover, the escalation of the military conflict over Nagorno-Karabakh, with its heavy costs in human and financial resources, has been further overcasting the general economic picture of the country, as well as increasingly constraining the Azeri authorities in their efforts aimed at economic reform and stabilization. Given these adverse circumstances, it should not come as a surprise that progress is emerging only slowly and that setbacks--at times even severe--will continue to jeopardize the success of the adjustment effort. However, the commitment of the Azeri authorities in this respect remains intact and deserves the support that our institution can provide.

Without paraphrasing the excellent staff report, I would like to recall the main issues where progress has been realized. At the same time, allow me to stress the main areas of concern, notably the recent fiscal deterioration and the hesitation surrounding the implementation of the currency reform.

On the promising side of the picture, Azerbaijan's economy underwent fundamental structural changes in 1992 as part of the effort to reorient the economy toward a market-based structure. Legislation on the central bank, banks, and banking activity was approved, providing the legal basis for a two-tier banking system. Some progress in the field of privatization was also achieved with the Parliament passing on January 7, 1993 the relevant basic legislation; the first specific privatization program is expected to be approved soon. With respect to enterprises, the changes in the system of price and wage determination, initiated at the beginning of 1992, allowed economic units to gain some independence in decision making. However, much remains to be done in this respect. In particular, no proper bankruptcy law has been enforced yet, and most enterprises still operate under soft financial constraints. Last, but not least, land reform remains in its infancy.

The uncertainties in the ruble zone and the urgent need to stabilize financial activities call for a swift introduction of an independent national currency. At present, the manat circulates in Azerbaijan alongside the Russian ruble. Its relative share in total currency circulation is rapidly growing, having approached

50 percent according to the most recent available information. The Azeri authorities have been forced to move in this direction owing to the severe shortage of rubles, stemming from the virtual stop in supply coupled with a substantial outflow that followed the price increases in December 1992. However, despite the fact that the manat is de facto replacing the ruble, the monetary authorities are reluctant to fully implement the currency reform. Fear of possible disruptions in interrepublican trade flows in the absence of a proper payment mechanism with the other FSU republics and a number of unsettled problems--like the withdrawal and restitution of rubles--gave reason for the use of caution in seeking total monetary independence.

The final goal of monetary independence is to improve financial and monetary conditions in Azerbaijan by protecting the country from the hyperinflation in the ruble zone. However, this presupposes the adoption of sufficient monetary and budgetary discipline in Azerbaijan itself. In this respect, the recent sharp deterioration of the fiscal stance, and the systematic monetization of the budget deficit by the Azerbaijan National Bank is worrisome. Following the good fiscal performance of the first nine months of 1992, when a surplus was recorded, the budgetary picture has been gradually deteriorating. On the one hand, part of the deterioration stems from the authorities' commendable undertaking of measures to improve transparency in the budget structure: with valuable technical assistance from the Fund, the fiscal authorities reduced considerably the use of extrabudgetary funds. On the other hand, a sharp turnaround of the fiscal stance occurred in the last term of 1992 under the cumulative effect of the price and wage increases of September and December. As for the 1993 budget, not yet approved by the Parliament, the fiscal deficit is projected to amount to 5 percent of GDP, although some underlying assumptions might be questioned. Developments on the expenditure side clearly show how the authorities' room for maneuver is shrinking: the war absorbs nearly one third of total expenditures, and a great deal of resources is devoted to building and safeguarding a social consensus.

Azerbaijan, with its large industrial and agricultural potential, will be able over the medium term to find its place in the world economy. The clear commitment of the authorities to modernize oil production, develop an industry of transformation, and diversify and reorient exports should be very attractive for foreign investors. However, despite the commendable efforts in stabilizing and reforming the economy, Azerbaijan can hardly expect to make decisive progress in this respect unless the conflict over Nagorno-Karabakh can be resolved. It will be very difficult to attract foreign capital on acceptable terms as long as Azerbaijan is at war. I hope that a peaceful settlement can soon be reached.

Mr. Kural made the following statement:

We welcome the first Article IV Consultation with Azerbaijan. During 1992, Azerbaijan encountered serious complications as it began the complex task of transforming its centrally planned economy into a market-based system, finding its structural reform program hampered not only by the output and price effects of price liberalization, but also by the Nagorno-Karabakh conflict. These obstacles, in combination with adverse weather conditions, have caused persistently high retail prices and unpredictable effects on costs and output, which are obscuring price signals and blocking market responses.

Recent economic developments, together with different points of departure and different itineraries, have caused the progress of reform in the republics of the FSU to vary widely. Progress has also been uneven in the policy components of given reform programs. The pace of domestic policy varies widely from republic to republic, and I share the authorities' concern about the difficulty encountered by smaller republics trying to pursue noninflationary financial policies in the ruble area, which is dominated by larger members exercising less financial discipline.

Table 1 of the staff report indicates that Azerbaijan's performance contrasted sharply with that of most other republics in the area of budgetary outcome, inflation rates, and the external position. During 1992, Azerbaijan made progress with respect to the coordination of economic and financial policies in the face of shocks, but much remains to be done in terms of strengthening the macroeconomic framework, expediting the requisite legislative changes in various key areas, and encouraging market-oriented behavior and efficiency in public enterprises.

The staff notes that Azerbaijan's reform progress has been slower than anticipated in certain areas. Therefore, I welcome the Law on Banks and Banking Activity and the Law on the National Bank, passed in August 1992, and the privatization law, passed on January 7, 1993. It will be essential to fill in the remaining gaps in the legal framework with respect to private sector development and to align the transformation of Azerbaijan's economy with developments in other republics. To this end, I urge the authorities to speedily remedy the institutional inadequacies, such as the absence of a proper bankruptcy law, that have so far kept them from dealing with the complexities of the transition process. The structural reform also needs to be made more transparent, and reassurances should be given to the international community that the momentum of the transition will be maintained.

The staff report accurately describes developments in 1992. The breakdown of the former mechanisms of central control, dislocations in the ruble area, and the conflict in Nagorno-Karabakh have effectively demolished the complex system of linkages between sectors and regions, with the result that the production decreases in some sectors in 1991 were followed by a continued sharp contraction of economic activity in 1992: preliminary estimates indicate that the outturn for GDP will be more than 26 percent the 1991 level. It should be noted that the evaluation of Azerbaijan's 1992 economic performance is subject to the usual deficiencies in data, especially with respect to the effect of liberalization measures and trade among FST republics.

Despite strong efforts to maintain fiscal discipline during 1992, Azerbaijan's inflation rate has reached a historic high. According to the staff, the policies being considered for 1993 are a response to the perilous situation created by external shocks. Additional fiscal reforms aimed at revitalizing the economy and supplementing the 1992 reforms recommended by the staff are being considered. Although tax measures will provide some control over the economy and spending reductions should strengthen the fiscal position during the reform, the present segmented structure of government revenues and expenditures interferes with these effects.

The remedy must begin with bringing transparency to the Government's fiscal operations by displaying implicit taxes and subsidies and the sources of extrabudgetary funds. The announced elimination of consumer subsidies is certainly an essential reform, but the adjustment of nominal wages through indexation must be approached with caution. Producer subsidies should be phased out gradually. The rich endowment of Azerbaijan with raw materials must not lead to selective restructuring of sectors, promising short-run results, since this would only create new imbalances among the different sectors of the economy. The authorities must also establish priorities for public investments aimed at encouraging private initiative, reduce subsidies on goods and services and transfers to state enterprises, monitor state enterprise wage increases, and strengthen enterprise management by legal and institutional reforms.

Basic fiscal changes will improve resource allocation and economic efficiency and set the stage for the desired supply response to reduce the rate of inflation. Things will get worse before getting better, but after the initial stage, as the supply response gains momentum, shortages will disappear, prices will stabilize, and exports to convertible currency areas will increase and provide a basis for a resumption of growth in the medium term. The immediate effects of the recovery program are thus positive in terms of their improvement of the price and balance of payments outlooks. The eventual recovery will reinforce outward-looking social and economic attitudes and gain public support for the continued pursuit of structural adjustment.

It is good that the authorities were not discouraged by the uncertainty clouding the external outlook during 1992 from setting the major goal of improving interrepublican trade performance and positioning Azerbaijan to begin trading directly in world markets when its medium-term balance of payments viability is established. The staff reports that the Azeri authorities are already looking forward to an orderly withdrawal from the ruble area. They intend to maintain trade relations with the ruble area in the short term, until an effective mechanism for interstate settlements is established, and they will take any measures needed to safeguard their medium-term balance of payments objectives for new markets. Their determination to unify the exchange rate system is laudable. However, the intensification of controls over trade in strategic goods is a cause for concern. Still to come are a drastic downsizing of the Government's role, creation of a stable, non-distorting regulatory framework, and a business environment favorable to private sector activity. The Black Sea Cooperation and Economic Cooperation Organization could help improve the coordination of government policies, particularly those connected with the implementation of reform.

As to monetary policy, it is imperative to give interest rates a larger role in promoting efficiency and mobilizing savings, and to enforce the reserve requirements for banks uniformly. As the inflation rate declines in 1993, the authorities should limit domestic credits to state-owned enterprises and end the preferential credit arrangements that have distorting effects on the financial system.

An appropriate macroeconomic framework must be in place before the manat can become the sole legal tender. Major strengthening of the institutional and technical capacities of the National Bank is also needed, including development of a framework for formulating and monitoring credit policy and establishing an adequate accounting and reporting system. The authorities are correct to approach the currency reform with caution to avoid upsetting existing social and economic balances and putting the reform's sustainability at risk. As to the choice of an appropriate exchange rate regime, the authorities intend to peg the currency initially to a major foreign currency, as a floating exchange rate is not feasible without a foreign exchange market and financial institutions to participate in it. Experience in Eastern Europe has shown that floating exchange rates can lead to enormous depreciations and inflationary pressures, with damage to confidence in the reform and stabilization programs.

At the present stage, the absence of budgetary constraints on real public sector wage increases could undermine the stabilization effort. Such increases should be governed by tax-based income policies, rather than rigid indexation, which would be unsustainably costly. Better targeting of public transfers to the poorest population groups is needed. Stronger financial discipline is a prerequisite for enterprise reform. In all these areas, continued technical assistance to develop adequate statistics would be extremely helpful. The ecological damage around Baku endangers agricultural output and requires attention to avoid an ecological disaster.

Azerbaijan's rich raw material resources, its mild climate, and fertile soils give it advantages relative to some other states of the FSU. But the continuing military conflict with Armenia jeopardizes the economic restructuring process, and an early settlement of this conflict is most desirable.

Mr. Al-Jasser made the following statement:

Azerbaijan is endowed with considerable natural resources that have enabled it to benefit from the transition to world market prices. This enviable situation rendered it conceivable that Azerbaijan might be able to avoid a major economic contraction, resulting from the disintegration of the Soviet Union. While this was the case in 1991, evidence indicates that a dramatic decline in output, along with a significant deterioration in the financial situation, occurred in 1992. This outcome is not surprising, as Azerbaijan--like other FSU economies--was extremely vulnerable to the dislocations resulting from the breakdown in the command system, the limited availability of administrative capacity and technical expertise necessary for a market economy, and the deterioration in the financial situation in the entire ruble area. Over and above these common problems, Azerbaijan is burdened with the ramifications of the Nagorno-Karabakh conflict, which represents a major distraction and a stumbling block to the authorities' economic stabilization and reform efforts. Consequently, I join the staff in hoping that the various avenues being pursued to resolve this conflict will be successful, as regional peace is essential if Azerbaijan is to realize its medium-term growth potential.

Despite these major difficulties, I am encouraged by the authorities' continued commitment to structural adjustment and economic transformation. Also, the authorities' efforts to contain macroeconomic imbalances in the face of significant exogenous shocks is commendable. Nevertheless, the financial situation is deteriorating markedly and resolute efforts are now needed to restore macroeconomic stability. In this context, financial instability within the ruble area has contributed greatly to Azerbaijan's financial difficulties. Therefore, I agree with the authorities that an exit from the ruble area may prove to be a necessary component of any stabilization package.

However, as the staff report indicates, the authorities need to introduce a separate currency in a determined manner, rather than through the piecemeal approach that is currently in place. Moreover, it is imperative that the ongoing fiscal expansion be reversed prior to the complete introduction of the new currency. While the absence of financial discipline in the ruble area hinders the noninflationary strategies of smaller members of the ruble area, a full currency changeover is a once and for all measure that must not be compromised by lax domestic financial policies. Therefore, while I welcome the authorities' efforts to address the deterioration in public finances, including the increased transparency of public expenditures, further major deficit-reduction measures are required.

Budget revenues are projected to increase by 10 percentage points of GDP to reach 40 percent of GDP in 1993, while expenditures will increase by the same amount to reach 45 percent of GDP. However, the staff maintains that the revenue estimates may prove to be overly optimistic, thereby resulting in an even larger overall deficit. It is obvious that the authorities are moving in the wrong direction, since the share of revenues and expenditures is increasing rather than declining, which goes against the effort to reduce the role of the public sector in the economy. All revenue measures should strive to improve the structure of public revenues in terms of rendering the tax system more efficient, rather than raising revenues. Clearly, fiscal consolidation should be achieved primarily through a reduction in public expenditures.

I fully endorse the staff recommendations on the need to streamline and better target the social safety net. In addition, the attempt to maintain real wages through rigid indexation mechanisms should be abandoned, as that would adversely affect fiscal consolidation and aggravate inflationary pressures. Moreover, I share the staff's concerns about the preferential scheme for private entrepreneurs. Given the current fiscal situation, the initiation of new spending programs should clearly be avoided, while every effort should be exerted to reduce subsidies and transfers. In this respect, it is imperative for public enterprises to face hard budget constraints.

As to monetary policy, the planned currency changeover underscores the need for an overhaul of the current credit policies and interest rate structure. Moreover, it is imperative to resolve the problems of interenterprise arrears and ensure that banks do not lend to bankrupt enterprises so as to facilitate the conduct of monetary policy. In addition, I sympathize with the authorities for their hesitation in deciding on an appropriate exchange rate regime. Nevertheless, I strongly endorse the staff's view that under any exchange rate regime, it is crucial to adopt anti-inflationary macroeconomic policies that sustain confidence in the currency.

As Mr. Kaeser indicated in his helpful opening statement, in 1992 Azerbaijan's economy underwent fundamental structural changes as part of an effort to reorient the economy toward a market-based structure. To this end, welcome legislation has been approved, important steps toward exchange and price liberalization have been implemented, and some progress in privatization and public enterprise reform occurred. These efforts are a welcome first step that needs to be consolidated and built upon in a timely manner, so as to ensure the existence of a critical mass of reforms necessary to place the economy on an unambiguous path toward a market system. Indeed, as the authorities recognize, much more remains to be done in this respect. Clearly, the favorable balance of payments prospects should prove to be conducive to the resolute implementation of structural reforms along the lines suggested by the staff. However, the authorities' efforts will need to be buttressed by adequate technical assistance from the Fund as well as from other multilateral and bilateral sources.

Mr. Havrylyshyn made the following statement:

I am pleased to be participating in the first Article IV Consultation with Azerbaijan. The current discussion attests to Azerbaijan's desire to play its full role as a member of this institution and to participate in the cooperative spirit between nations that Fund membership engenders.

Although Azerbaijan faces many of the same problems as other FSU countries, on balance it has managed to do better than most of the others. While its GDP fell by 30 percent in 1992, for 1991 and 1992 together output fell by less than in the other small republics. Most encouragingly, the state budget deficit on a cash basis has been kept to 4.2 percent in 1992 and is estimated, albeit on some uncertain assumptions, to be about 5 percent in 1993, even with the inclusion in the budget of the substantial expenditures on bread subsidies and defence. I wonder about the extent to which the slippage in the fourth quarter of 1992 is attributable to the better-quality data recently provided; and to what extent it was in fact a real fiscal slippage. It is encouraging to note that Azerbaijan's surpluses on the trade and current account of the balance of payments are in sharp contrast to the deficits of most other FSU states.

Given this situation, Azerbaijan seems to be in better shape than most other republics to pursue successfully the required stabilization and reform policies, which would lead it through the transition to a fully fledged market economy. Certainly the authorities have much to do. I endorse the thrust of the staff's appraisal, and I agree with its recommendations, as well as with Mr. Kaeser's views on the medium-term potential of Azerbaijan. I also agree with Mr. Kaeser's comments emphasizing the overriding importance of resolving peacefully the conflict over Nagorno-Karabakh. I will limit my comments to the interesting puzzle of how Azerbaijan has been able to keep inflation rates lower than its ruble area partners and the urgency of introducing the manat as a full currency.

The combination of a fall in output, very high wage and social benefits increases, and price liberalization, do not seem consistent with the relatively lower inflation rate observed in Azerbaijan. In the light of the fact that Azerbaijan is still in the ruble area, with much higher rates of inflation, I wonder what has kept the inflation rate lower, and what has prevented substantial leakage of goods to the ruble area where prices are higher.

The answer may lie in two phenomena. There is evidence that control of prices still seems to exist, both because of the "mark-up" arrangements that apply to "liberalized" prices and because state enterprises perhaps continue to be given directives on price increases. In a word, there may still be repressed inflation as a result of the type of price liberalization adopted. Also, while lower prices would doubtless drive goods to the ruble area, this is not so noticeable, as hard currency imports facilitated by Azerbaijan's relatively good export performance fill the excess demand gap. I wonder whether the staff could comment on the possibility of repressed inflation and the problem of leakage of goods to the ruble area.

I am disappointed by the authorities' decision to postpone the introduction of their own currency, and I join Mr. Kaeser in urging this as soon as possible. Given the strong external position of Azerbaijan and its need to develop even further its export potential, particularly for petroleum, it should give greater emphasis to its orientation to world markets. It has already issued an amount of its own currency equivalent to some 50 percent of currency outstanding at the end of 1992, as a result of worsening ruble shortages. Thus, while I appreciate the authorities' concern about the resolution of the withdrawal and restitution of the ruble question and their desire not to disrupt further trade with other FSU countries--a problem that is exaggerated--the move to introduce its own currency would be in the best interest of Azerbaijan. Not only would this integrate it even sooner into the world market, but it would also help to enforce fiscal and monetary discipline, while at the same time shielding it from the inflationary pressures originating from the ruble zone. I agree with Mr. Al-Jasser that the introduction of Azerbaijan's own currency must be a necessary component of a stabilization program, not a result of such a program.

Mr. Al-Jasser asked whether the staff could comment on the risks associated with introducing the manat, especially in terms of the trade-off of risks involved in deciding either to introduce the manat at the present stage, when financial policies were not sufficiently stable, or to wait until the issues related to restitution and withdrawal of the ruble were resolved.

Mr. Golriz made the following statement:

Azerbaijan's economic performance in 1992 was uneven in general, and recent information in the supplement to the staff report leaves less room for optimism. Characterized as an open economy endowed with rich natural resources, Azerbaijan could likely demonstrate a better achievement had it not faced a regional conflict and adverse weather conditions. We agree with the thrust of the staff appraisal and have only a few brief comments.

The aggregate output in 1992 showed less contraction compared with most republics of the FSU. This was to some extent due to the quick response of the export sector to opportunities in markets in regions other than the FSU. Another factor is perhaps the delayed privatization that has limited the magnitude of output disruption. As the staff report notes, the state's role in the national economy remains pervasive: 85 percent in agriculture and almost 100 percent in industry, energy, and external trade. The large role of the Government in the economy is also evidenced by the fact that, despite the drop in output in recent years, the level of unemployment remains unchanged.

The transformation to a market-oriented economy has been impeded by the lack of a legal framework and the need for expertise. We are pleased to note that the authorities are cognizant of the legal gaps, and initiatives are under way to fill them. Azerbaijan needs to prepare the ground for entrepreneurial initiatives.

The price liberalization process has come a long way toward establishing a better balance between supply and demand, although there are several items that are still heavily subsidized, such as petroleum products--which are currently priced at 12-40 percent of the world level.

We agree with the staff on future Fund technical assistance to Azerbaijan, but we would emphasize the urgent need to improve the procedures for collecting statistics.

As Mr. Kaeser pointed out in his opening statement, the fiscal situation deteriorated in the final quarter of 1992, despite efforts to strengthen revenues. This was a consequence of measures taken to mitigate the hardships caused by adjustments. The value-added tax introduced in early 1992 will certainly enhance the tax base. We urge the authorities to extend the coverage of the value-added tax to include imports from non-FSU countries, especially since, at present, no duty is imposed on imports. We would also caution the authorities against introducing a differential value-added tax rate structure. We concur with the staff recommendation for removing export taxes as the exchange rate is unified and price liberalization presses ahead.

The primary task with respect to expenditures is to reduce the burden of the state-owned enterprises on the budget through the privatization and rehabilitation of financially weak firms. The present system of generalized subsidies and a generous social safety net that cost about 25 percent of GDP in 1992, is not only a heavy burden on the Government, but it also has distortionary effects on the economy. This system should be substituted by a scheme targeted at the most vulnerable groups. There are a number of references in the staff report to the need for a better designed social protection program that is more cost efficient and better targeted. I wonder whether the Fund has provided--or intends to provide--any technical assistance in this area.

There is a risk that the recent adjustment in wage levels could trigger a wage-price spiral that would be difficult to control. However, the authorities seem to be cognizant of the risks inherent in adopting rigid wage-indexation mechanisms and have chosen not to implement the indexation law. This is welcome. However, the staff's advice on how wage policy should operate is a little vague, as it is confined only to urging the authorities to find ways to containing excessive wage growth. I wonder whether the staff could comment on this point.

With respect to the choice of an appropriate exchange rate regime, there is some merit in the staff's suggestion to adopt a floating exchange rate until stabilization policies bring inflation under control and there is an adequate cushion of foreign exchange reserves. The staff is also correct to stress that, irrespective of the choice of an exchange regime, restraint in financial policies is a necessary precondition for sustaining confidence in the currency. In this respect, I wonder whether the staff has discussed the possibility of establishing a currency board with the authorities.

Some procedures in the banking system should be re-examined. The minimum capital requirement of rub 200,000 required to start a bank is extremely low. Based on prevailing exchange rates, it is close to $500. Even increasing it to the proposed level of rub 10 million, which is equivalent to $25,000, would still be low by any standard. Interest rates remain negative by far, and banks continue to extend credits based on the ability to pay principal. While most prices have been liberalized, enterprises have an unfair advantage of receiving cheap financing. At the same time, paying 6-25 percent a year on deposits by the banks, which is far below the monthly inflation rate, could increase the risk of a run on the banks. We also note that banks are not required to make provisions for bad debts and write-offs are uncommon. This can hardly be considered an acceptable banking practice and could endanger the balance sheets of the banks.

There is great potential for cooperation in a regional trade arrangement, given the openness of Azerbaijan's economy and its traditional trade and cultural relations with neighboring countries, which should guarantee durable growth for the Azeri economy. These benefits will materialize, as pointed out by Mr. Kaeser, if political stability is secured by achieving a lasting peace in the region as a necessary basis for the envisaged macroeconomic adjustments.

With these remarks, we support the proposed decision.

Mr. Dorrington made the following statement:

The events in Nagorno-Karabakh have overshadowed some significant positive developments in Azerbaijan in the early part of 1992, in particular, a current account surplus, a fiscal surplus during the first nine months, inflation rates lower than elsewhere in the FSU, success in diversifying trade away from traditional FSU markets, and progress in establishing a two-tier banking system. All of these developments are welcome, and I also welcome more recent moves to increase transparency.

It is clear that the conflict in Nagorno-Karabakh is resulting in a major diversion of both productive resources and policymakers' time, and deterring foreign investment. The full benefits of reforms will obviously not be seen until the dispute is resolved. But when it has been resolved, the potential for Azerbaijan must be as great as anywhere in the FSU. In particular, it is well endowed with natural resources and it is thought to have substantial energy resources under the Caspian Sea.

However, the situation seems to have been deteriorating rapidly. As the details are given in the staff report and in the supplement to the staff report, I will not repeat them.

Azerbaijan is facing the historic decision to launch a fully independent currency. While Directors have expressed different views on this, the transition to use of its own currency will give Azerbaijan a unique opportunity to make a new start and to break the inflationary spiral. If this opportunity is not taken, the subsequent task will be much greater. Thus, it is essential that flexible markets and appropriate financial institutions be established before the new currency is launched. In particular, prices of goods must be close to market-clearing levels. If possible, it is important to ensure that arrangements for the continuation of smooth payments and trade within the FSU be in place. I wonder whether the staff could comment on Mr. Havrylyshyn's suggestion that problems in this area are exaggerated. Mr. Mozhin and others with FSU countries in their constituencies may also wish to comment on this.

Similarly, attempting to fix the exchange rate of the manat before the inflation rate is reasonably under control would almost certainly not be sustainable. Given the large share of international trade in Azerbaijan's GDP and the need for substantial foreign direct investment, it would be better to let the currency float until conditions for a sustainable fixed rate are in place than to risk the fixed exchange rate being a failure with all the loss of credibility that would entail.

Thus, the job to be done is both massive and urgent. While there are limits on the speed with which reforms can be implemented, I am far from convinced that the authorities are doing as much as they could. For example, the staff report indicates that controls on the exchange and payments system are increasing. Given the fiscal demands of the war and the overall fiscal position, I wonder why the rate of the value-added tax was reduced. While interest rates are set to increase, a rate of about 35 percent per annum is massively negative in real terms and below the rates in other parts of the ruble zone. Some of the new measures proposed go against the markets, such as differential interest rates and safety nets that are so large as to present disincentives and to impose a massive cost on the rest of the economy. Although I can sympathize with the authorities on the objectives of distorting measures designed to encourage new enterprises, their subsequent removal could be very difficult, and it would almost certainly have been better not to introduce them in the first place. In short, I agree with the staff's comments on this issue.

The clear way in which most of the facts, the views of the authorities and the views of the staff are presented in the staff report is welcome. Differences of view are sharply exposed in the staff report, and that is exactly how it should be. However, I regret that more effort was not made to separate out the effects of oil on the various statistics in order to give a better picture of developments in the non-oil sector. For example, Table 1 of the supplement to SM/93/33 shows that government revenue as a percentage of GDP is planned to increase by 10 percentage points between 1992 and 1993, but from the detailed body of the table it can be deduced that, after excluding value-added tax, excise duties, and royalties on oil, the increase is only 2 percentage points, and the staff expressed doubts that this will be forthcoming. However, it is not possible to calculate the decline in non-oil GDP for 1992 from the figures for GDP in rubles and oil output in tons, but it must be more than the 30 percent of total GDP.

I appreciate the problems the staff encounters in deriving accurate detailed figures, but relevant, approximately correct figures, with appropriate qualifying comments, would be very welcome in future staff reports. In order to avoid increasing the overall volume of information presented, I would be content to do without, for example, monthly data on increases in the price of ice cream.

The staff representative from the European II Department said that, although the state budget had recorded a surplus on a cumulative basis through the third quarter of 1992, a small deficit was registered in the third quarter, and the imbalance had intensified in the fourth quarter. Thus, there had clearly been an overall weakening of the underlying fiscal position during the last two quarters of 1992. The deterioration in the fiscal position, which appeared to have continued in early 1993, reflected mainly the cumulative impact of the sharp price and wage adjustments that were undertaken in September and December 1992, as well as the Government's attempts to eliminate the payments arrears accumulated through the third quarter of 1992. The measured deterioration was not attributable to an improvement in the quality of available data. Attempts to improve the coverage of data were reflected in the state budget for 1993.

A comparison between the inflation rates in Azerbaijan and those in other FSU countries would need to take into account data deficiencies in these countries, particularly with respect to price statistics in Azerbaijan, the staff representative considered. Nevertheless, the rate of inflation in Azerbaijan, as measured by the retail price index, was lower. This could partly be attributed to the current system of controls on price increases by state-owned enterprises, which had a monopoly in traded goods. The retail price markups applied to consumer goods sold domestically had ranged from 10-25 percent of costs. While considerable progress toward price liberalization had been made throughout the year, the results may not have been as effective as the movement of goods into the liberalized category would imply.

Some leakage of goods across borders had taken place in 1992, the staff representative said. While the authorities did not have a firm measure of the extent of such leakages, they had expressed concern about it. The overall export system in Azerbaijan was fairly restrictive, as most exports were linked to trade agreements. In addition, the authorities had attempted to control the leakage of goods across borders by requiring certain payments in the border areas to be made in manats.

As to the issue of whether Azerbaijan should introduce its own currency at the present stage or wait until financial conditions were more stable and payments arrangements with other FSU countries were in place, it was important to bear in mind that both alternatives involved substantial risks, the staff representative commented. In the current circumstances, the staff had encouraged the authorities to move forward with the introduction of the manat, while ensuring that the appropriate macroeconomic and financial policies were put in place to make the transition to the national currency viable.

The staff agreed with Directors that the current social safety net was a drain on public sector resources, the staff representative stated. During two recent missions, staff from the Fiscal Affairs Department had tried to help the authorities identify areas of excess and better target social benefits. It should be noted that although the Fund had not yet provided technical assistance to Azerbaijan in the area of the social safety net, this was one of the areas that had been identified for possible technical assistance in the period ahead.

In its discussions with the authorities on wage policy, the staff had discouraged the strict indexation of wages, either by law or in practice, the staff representative said. As Azerbaijan made the transition to its own currency and the rate of inflation was brought down, the staff would continue to encourage the authorities to take a forward-looking approach to wage policy by not allowing automatic wage adjustments to be made on the basis of past inflation rates. The staff had placed particular emphasis on wage policy with respect to the state-owned enterprise sector, where there was clearly room for greater wage discipline, the staff representative continued. The staff had strongly recommended tighter overall budget constraints on state-owned enterprises, which would not leave room for excessive wage awards in the future.

The views of the authorities and the staff differed with respect to the choice of the exchange rate regime to be adopted with the move to the national currency, the staff representative noted. While the staff had advocated the use of a floating exchange rate system, at least until the reserve position could be strengthened, sound financial policies could firmly take hold, and the institutional capacity of the banking system could be developed, the authorities tended to favor the use of a pegged exchange rate. Although the staff had not yet discussed the introduction of a currency board with the authorities in detail, the authorities had shown some interest in this option in considering all the possible alternatives carefully in the present circumstances facing Azerbaijan's economy.

In the light of recent developments, the staff did not consider that the introduction of the national currency in Azerbaijan would lead to a significant disruption of trade with other states of the FSU, the staff representative from the European II Department commented. The authorities were working closely with the authorities of other FSU countries to put in place the arrangements needed to allow for external payments to continue smoothly after the move to the manat was completed. As foreign exchange earnings increased, a growing part of settlements could be expected to be made in convertible foreign currencies.

Mr. Burdiel made the following statement:

The significant deterioration in Azerbaijan's financial situation raises some concerns. Despite the unfavorable environment, the authorities had managed to keep macroeconomic imbalances within bounds during the major part of 1992. More recently, however, public sector finances have deteriorated substantially, and the successful introduction of the national currency is being jeopardized by the lack of supporting financial policies and institution-building reform efforts.

In 1992, output declined more than anticipated, while December 1992 price increases in bread, energy, and oil have led to a dramatic rise in the rate of inflation. The consequent minimum wage increase in early 1993 has triggered rises in wages, salaries, and social benefits, contributing to the deterioration of public sector finances and threatening stabilization perspectives and the successful complete adoption of the manat.

Although commendable efforts in pursuit of economic reform and stabilization have been made in the past, the Azeri authorities should reinforce their commitment in that direction in order to attain the conditions for low inflation rates and strong sustained rates of growth, thus realizing the considerable potential of Azerbaijan's rich natural resources.

Demand for financial resources will be a heavy burden on the fiscal consolidation efforts as long as the Nagorno-Karabakh conflict persists. The situation requires more rigorous fiscal policies, which is incompatible with increasing, or even maintaining, the purchasing power of social benefits. Further financial discipline in state enterprises should also be implemented to improve public finances, while pursuing the effective restructuring of this sector.

Full introduction of the manat should be implemented with determination, given the existing monetary latitude in the ruble zone. In this respect, budgetary discipline--putting an end to the financing of budget deficits by the central bank, implementing strict limits on bank credit to state enterprises, and adjusting the demand for credit through a consistent interest rate policy--is mandatory for the credibility of the new currency. These would be, among other things, crucial policies to attract foreign investment, which is much needed in the oil industry. Although, as long as the military conflict persists, foreign investment is not likely to flow in.

The authorities should be commended for not implementing the indexation law, but a more consistent forward-looking wage policy should be carried out. When output is so seriously declining and the rate of inflation is over 1000 percent, increasing--or even maintaining--real wages is unsustainable in the medium term. In the short run, it is very disruptive to the needed stabilization process and threatens the credibility of the new currency. Even in the presence of terms of trade gains, wage constraints are required for the recovery of output. To supplement these constraints, and taking into account the needed budgetary discipline, a social protection policy targeting exclusively the hardest-hit segments of the population should be implemented.

Azerbaijan is facing a crucial period. While I recommend that the Azeri authorities make ceaseless efforts to end the military conflict and stronger commitments to stabilize and reform the economy, the authorities deserve our support. Technical assistance should continue to be provided by the staff, and the stationing of resident experts in Baku should be given favorable consideration. We support the proposed decision.

Mrs. Farid made the following statement:

Despite the economic and political difficulties of the past year, including the continued military conflict in Nagorno-Karabakh, Azerbaijan's economic performance compared fairly favorably with that of other FSU states. However, the significant deterioration in Azerbaijan's financial situation in the last quarter of 1992 is a matter of concern to the extent that it was not brought about by increased transparency in the budget, as the staff has noted. Firm adherence to prudent macroeconomic policies in the future will be essential if Azerbaijan is to realize the strong potential for growth that its rich natural resource endowment points to. These policies should aim at financial stability, a radical reduction in the size and role of the Government within the economy, and the creation of a stable and nondiscriminatory regulatory environment. An essential precondition for such policies must, however, be an upgrading of the economic data, particularly the state budget figures, making them more comprehensive and transparent. In this respect, we welcome the recent inclusion of the bread production subsidy and defense spending in the state budget. The inclusion of all off-budget categories will further facilitate the assessment of the public sector's overall position.

While the authorities made a strong effort to maintain fiscal discipline in the first three quarters of 1992, serious slippages occurred in the last quarter and spilled over into the first month of 1993. The revised 1992 state budget showed an estimated overall deficit of 4.2 percent of GDP compared with a budget surplus of 2.6 percent in 1991. The staff report indicates that much of the deterioration was due to the cumulative impact of the price and wage increases in September and December of 1992. The further wage increase that took place in January 1993 adds to our concern, as does the expected 1993 deficit in the Social Protection Fund, which is estimated at 3 percent of GDP. The attempt to maintain real wages and the rise in social security spending without adequate compensating expenditure cuts seems to be clearly unsustainable.

As to price liberalization, despite the commendable progress of 1992, domestic prices of several goods remain substantially below international prices. Energy, in particular, continues to be substantially underpriced, with gasoline, fuel oil, and diesel at 43 percent, 12 percent, and 28 percent of international prices, respectively.

With respect to monetary policy, it is disturbing to note the extraordinary eightfold increase in credit to public enterprises compared with 1991, as well as an accumulation of enterprise arrears to banks and other enterprises reaching 24 percent of total domestic credit outstanding at end-December 1992. The fact that these arrears doubled in the last two months of 1992 adds to the urgency of imposing hard budgetary constraints on public enterprises, while setting credit ceilings to contain domestic credit growth until indirect monetary instruments are put into place. The highly negative real interest rates should also be adjusted upward sufficiently so that borrowing for speculative purposes is eliminated and savings mobilized. The authorities should also refrain from allocating credit at preferential interest rates.

We agree with the staff that the implementation of the currency reform should be done in a deliberate manner within an overall program of stabilization and reform and that particular emphasis should be placed on the buildup of institutional capacity to manage monetary and exchange rate policies. The fact that the move to the manat is effectively taking place even though its official introduction has been postponed, only adds to the urgency of adopting appropriate policies to bolster confidence in the new currency and to maintain financial stability.

We note that the authorities have not yet taken a decision on the choice of an exchange rate regime, after having been previously inclined to peg the manat to a major currency. While the recent substantial downward revision of the estimate of foreign exchange reserves may justify the choice of a floating exchange rate, we wonder whether the staff could comment on the risks associated with introducing a floating exchange rate before stabilization measures have had time to take hold.

In conclusion, we commend the Azeri authorities for the steps they have taken so far in the transformation of their economy and wish them well in their continued efforts in the midst of undoubtedly difficult circumstances.

Mr. Abbott made the following statement:

We have two main areas of concern about the prospects for reforming and stabilizing Azerbaijan's economy in the current economic context. The first relates to the importance of sequencing of financial policy measures versus technical policy preparation. The second relates to the need for the authorities to aim--despite the cacophony of competing interests and advice--at simplicity and transparency in implementing structural change in the economy.

A successful move to a national currency demands the preexistence of tight monetary and fiscal policies. The authorities seem to have spent considerable time preparing the technical groundwork and mechanics for introducing the manat as a sole currency, while delaying the formal introduction of the new currency. In the meantime, however, circulation of the manat has grown to some 50 percent of the currency stock, despite the fact that little attention has been paid to putting the necessary financial policies in place. Moving out of a currency zone to a sole national currency will expose poor domestic financial policies and no longer allow the luxury of pointing to behavior of other economies as the main source of domestic inflation.

Despite noble efforts to curb the fiscal deficit in 1992, the fiscal stance is now clearly deteriorating and monetary control appears to be nonexistent. We fully support the staff's suggestions for tightening the fiscal accounts by cutting back on subsidies, pensions, and military expenditures. We are also concerned about the unrestrained credit growth to enterprises, the full bank financing of the expanding fiscal deficit, and the pressures these put on domestic prices. These are likely to be a much greater source of instability than the price liberalization, that is so feared by the authorities.

Similarly, while we are encouraged by the fact that the financial authorities are giving attention to the technicalities of indirect methods of monetary control, their first priority should be the introduction of a realistic interest rate policy.

This should involve moving the refinance rate to positive real levels or at least to levels consistent with those in other key republics. Such a move would be far more effective in preventing capital flight than the distorted exchange rate schemes currently in place. As a parallel interim step, credit ceilings should be enforced and subsidized, and direct lending should be eliminated.

We agree with the staff that existing conditions in Azerbaijan suggest the need to float the manat, at least initially. Even if a temporary equilibrium rate were somehow determined, the financial and structural situation is in such flux in Azerbaijan that a sustainable level is not likely to be known for some time. Further, a pegged exchange rate is not likely to hold, given the impact of the current level of reserves and the financial policy stance on market credibility.

Future balanced growth in Azerbaijan requires cultivation of new foreign and domestic investment beyond the energy sector. But, the current hash of layers of uncompleted and complicated policies act more as disincentives than as encouragement to the still largely absent private sector. Accordingly, we believe the authorities should expedite the passage of key legislation establishing the legal basis for private sector activity and simplifying the economy's structure rather than introduce new distortions or prolong old ones. For example, the current tax and revenue system has a significant structural impact on the economy in addition to the financial effects already mentioned. The changes in the past year have added layers of inconsistent measures that result in a confusing set of incentives. A simpler tax system, minimizing the number of rates, exemptions, and odd special taxes, would not only be simpler to administer but would also make for more rational economic decisionmaking. Specifically, lowering the high social security tax and the excess profit tax, which has little revenue benefit, would likely be more effective in spurring a supply response than the special fund providing interest-free loans to private entrepreneurs.

The price liberalization already enacted was effectively curtailed by the restrictions on changes in prices of the 80-90 percent of goods produced by monopolies. The result of the incomplete price liberalization is highly distorted price signals, leading the responses of the market, such as it is, to be slow, confused, and inarticulate. Similarly, faster export growth is stymied by the counterproductive policy of labeling 80 percent of exports as strategic and, therefore, subject to controls. Full price and trade liberalization would go far toward improving the economic climate for private sector activity.

Finally, the ongoing conflict with Armenia could be seen to place Azerbaijan in triple jeopardy by inflating the budget deficit and the price level, distorting the economy's market reactions, and distracting the authorities from taking the broad perspective needed during this critical transition period for Azerbaijan's economy. Reference has been made by most, if not every speaker to Azerbaijan's relatively strong position relative to other FSU countries, given its past fiscal conservatism and existing economic structure and natural resources. However, sufficient consideration needs to be given to the long-term effects of current policies to ensure that these resources are not squandered.

Mr. Mozhin made the following statement:

Before reading the staff report for the current discussion, the most basic fact I knew about the Azeri economy was that it was in a very early stage of the economic reform process. It is rather difficult to reconcile this fact with some of the conclusions in the initial staff report, which seems to be overly optimistic. The predicted end of the decline in output by the end of 1993 seemed to be especially doubtful.

The analysis and data in the staff report--on several points--seem to contradict these optimistic conclusions. The enterprise reform has hardly begun, and even a legal framework for it remains very rudimentary. Budgetary and fiscal administration processes evidently suffer from a lack of clarity and transparency. Soft credits and the lack of financial discipline in the enterprise sector were also mentioned. Yet, it looks as though the relatively low rate of inflation and small budget deficit were interpreted as signals of the forthcoming stabilization in 1993 and subsequent growth.

Therefore, it was not surprising--although worrisome--that the supplement to the staff report, which was circulated on March 16, 1993, revealed the rapid deterioration of the general economic situation, including the decline in output of about 30 percent in 1992 as a whole; the much higher than anticipated rate of inflation; and the size of interenterprise arrears, which has doubled in a two-month period.

I am in broad agreement with the staff appraisal. The emphasis remains on the removal of restrictions on payments and settlements for current international transactions and accelerated conversion to the manat under a floating exchange rate as opposed to a pegged exchange rate regime. Of course, the success of the manat will depend on the implementation of adequate financial policies. I welcome the willingness of the new Azeri authorities to accelerate the privatization process. This seems to be an important change of attitude compared with that of the previous Administration.

Like other FSU countries, Azerbaijan needs a lot of technical assistance from the international community in order to achieve visible progress. The supplement to the staff report repeats the recommendations contained in SM/93/33, namely, to provide the Azeri authorities with advisors on fiscal and monetary issues and to establish a resident representative of the Fund in Baku. I would also stress the urgency of organizing training programs in institutional matters, finance, and restructuring.

Of course, the most important reason for the continuing deterioration of the economic situation is the ongoing war in Nagorno-Karabakh, which literally strips the state of financial resources that are crucial for economic transformation.

The current Article IV consultation could be instrumental in the elaboration of a more ambitious economic program for Azerbaijan.

Mr. Dognin made the following statement:

The Azeri authorities made noteworthy progress in 1992 toward a market economy. They should be commended, in particular, for having maintained relatively strong fiscal discipline, despite a difficult economic and financial environment.

Looking ahead, Azerbaijan enjoys a fairly good potential for growth in the oil and agriculture sectors, and prospects for external viability seem to be promising, provided the necessary reforms and restructuring are carried out in a timely manner. Such favorable prospects give serious justification for the authorities' move toward the adoption of a national currency.

In the transition period, however, it will be crucial to avoid further disruptions in the industrial sector. I note with satisfaction that the authorities are actively seeking to put in place bilateral payment arrangements with the Russian Federation and other FSU republics with which important trade links will be maintained.

While the move to introduce a national currency might bring about over time an increased latitude in economic management, such a beneficial impact hinges on the strength of the initial stabilization process and on the pace of implementation of fundamental reforms, especially in the banking and exchange and trade systems. Therefore, the sequencing of reforms will be paramount, and I would like to emphasize, in that respect, three areas that should be given priority.

In the fiscal area, it should be first recognized that the authorities made commendable progress on the revenue side to compensate for the loss of grants from the FSU in 1992. The next step, as recommended by the staff, is to broaden the tax base, namely, by levying duties on imports from non-FSU countries, while seeking a more simplified tax structure.

The restrained stance with respect to expenditure adopted by the authorities in 1992 bodes well for the fiscal part of the stabilization program. Nevertheless, expenditure developments at the end of 1992, namely, the growing share of social benefits and price subsidies, and the corresponding decline in other expenditures, especially investments, point to the need for early actions, first, to broaden the coverage of the budget and, second, to seek a better targeting of the social safety net. This might be all the more important, given that the restructuring of state enterprises and the reform of the civil service as well as the overall adjustment process are likely to trigger additional budgetary outlays.

The credibility and eventually the stability of the new currency will closely depend on the authorities' success in abating inflation. Therefore, I fully agree with the staff that domestic prices should be adjusted toward international levels prior to adopting a national currency to escape a dramatic loss of confidence at the outset.

Another important precondition is the effective institution of a two-tier banking sector. The rapid increase in credit to state enterprises at the end of 1992 and the rapidly growing number of commercial banks call for an active role by the central bank both to keep credit development in check and to ensure the enforcement of prudential ratios. In this respect, I particularly welcome the major headway that has been made recently in putting in place the appropriate regulatory framework, but its implementation will require further substantial technical assistance. I support the extensive and continued technical assistance provided by the Fund to Azerbaijan. The quality of the work done so far is demonstrated by the comprehensive recommendations set forth in the background paper.

Among those recommendations, and given the early stage of reforms in the banking sector, I fully agree with the emphasis the staff has placed on the recourse to credit ceilings as an initial instrument to control monetary development.

Another priority for the Government is to create the necessary conditions--namely, the legal and institutional framework--for an early recovery of growth. In this connection, as in the other areas of reform, the authorities' determination to move forcefully, especially in the restructuring of state enterprises, is particularly encouraging. Given Azerbaijan's heavy dependence on trade and the potential for export-led growth, the Government should take steps to eliminate the implicit tax on exports of strategic goods. This would allow for the building up of the financing capacities that enterprises will critically need to undertake the modernization process. In addition, I fully agree with the staff that a credible stabilization program would more efficiently prevent nonrepatriation of foreign exchange, because inflationary expectations and highly negative interest rates are probably the main factors encouraging unrecorded exports and the nonrepatriation of funds.

A clear and predictable legal and regulatory framework for foreign investments will also play a decisive role in the restructuring effort as the domestic savings capacity, in the initial phase of adjustment, is likely to be insufficient to match investment needs.

I join the staff in hoping that a peaceful resolution of the conflict over Nagorno-Karabakh will be sought to allow Azerbaijan to concentrate on the reform and modernization efforts and secure an economic environment conducive to investments.

Mr. Fridriksson made the following statement:

I welcome this first Article IV consultation with Azerbaijan. I can fully endorse the staff report and appraisal.

It is disappointing to note from the supplement to the staff report that Azerbaijan's economic situation has deteriorated very sharply in the last few months. Price developments reflect the danger signs of imminent hyperinflation. Against this background, the outlook for Azerbaijan's public finances and the prospects for a successful introduction of the national currency, the manat, have been badly damaged.

There are other problems as well, and a precondition for the economic stabilization and reform efforts to bear fruit is a resolution of the conflict over Nagorno-Karabakh. The draft State Budget for 1993 reveals the magnitude of the defence and military-related demands placed on financial resources. Even keeping in mind the problems stemming from--and preoccupations with--the conflict, I agree with Mr. Dorrington that the authorities are doing much too little in the area of macroeconomic stabilization, and I would like to echo Mr. Mozhin's wishes that the current consultation serve as an inspiration to the authorities to sharply strengthen their policies.

Well endowed with fertile agricultural land and a variety of mineral resources, however, Azerbaijan has a strong potential for rapid development. In this respect, it has a good starting position and an advantage compared with many other FSU countries in their transition process to a market economy. But, as emphasized in the Board's pre-membership economic review in April 1992, it is crucial to establish an appropriate macroeconomic environment and a regulatory framework for the growth potential to be exploited. According to the staff report, the authorities were committed to adopting commercial law, property law, contract law, bankruptcy law, and customs law by early 1993. I wonder whether the staff could comment on progress in establishing the appropriate legal framework.

While Azerbaijan appears to have benefited from a terms of trade gain in 1992, there has been a sharp drop in output, and the situation in the monetary area remains very difficult. Huge imbalances have, of course, developed in the whole ruble area, and financial policies appear to have been very lax in Azerbaijan, as evidenced by the recent sharp deterioration in public sector finances. The attempt to maintain real wages and to increase social benefits in the face of rising inflation rates and declines in output, as pointed out by the staff, are clearly unsustainable. The authorities must regain control over the credit expansion and improve the financial discipline in state enterprises. It is clear that the administrative allocation of credit with the upward rigidity of interest rates have encouraged borrowing for speculative purposes. The authorities have to significantly tighten monetary control, establish a market-oriented interest rate structure, and introduce effective measures to stop the accumulation of interenterprise arrears.

Azerbaijan has little choice but to declare the manat as the sole legal tender. However, before doing so, it needs to establish a coherent macroeconomic policy. Moreover, the authorities must make further progress in the area of price liberalization, aligning domestic and international prices.

The key element of budgetary policy should be to limit government spending and increase its efficiency.

The tax reform being implemented should not curb private initiative. The present export taxes have to be phased out. The exchange system for strategic goods is used only to subsidize public sector imports, without any revenue accruing to the budget from this source.

Finally, the lack of comprehensive statistical data is a problem that the Fund faces in all the FSU countries. This complicates the design of proper policies and the monitoring of developments. It is clear that the Fund can contribute much by technical assistance in this area.

Mr. Nakagawa said that, like previous speakers, he welcomed the performance of Azerbaijan, which was better than other countries of the FSU. Nevertheless, he was deeply concerned about the rapid deterioration in the fiscal position since the last quarter of 1992. In the light of that deterioration, he joined other speakers in stressing the urgent need for the authorities to take substantial measures to tighten fiscal policy in the coming period. In that connection, the need to better target benefits under the social safety net and to constrain wage growth should be stressed.

He agreed with other Directors that the introduction of a national currency should be a component of a comprehensive stabilization program, Mr. Nakagawa commented. On the choice of exchange regime, like Mr. Dorrington, he supported the staff's position that the floating exchange rate system would be the best alternatives, in light of the current situation with respect to foreign exchange reserves. However, under any exchange rate regime, it would be important to emphasize the urgent need for tight financial policies to establish credibility in the implementation of sound macroeconomic policies.

He also joined Mr. Dorrington and other speakers in hoping that the conflict in Nagorno-Karabakh would be resolved as quickly as possible so that the Azeri authorities could concentrate on the economic reform on a full-fledged basis, Mr. Nakagawa stated.

Mr. Ismael made the following statement:

> I welcome Azerbaijan's strong efforts in transforming its centrally planned economy into a market-oriented one. I am pleased to note that since 1992, reforms have kept macroeconomic imbalances within bounds, and the measures initiated have helped to correct structural weaknesses inherited from the old economic system.
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> However, I also note that these efforts were not persistently sustained and significant slippages did occur, resulting in a larger than previously envisaged budget deficit. As budgetary discipline and transparency are key requirements for keeping runaway inflation rates under control and for supporting reform efforts, I urge the authorities to strengthen their efforts in furthering fiscal stability. While some unproductive expenditure is unavoidable under the present circumstance, the incomes policy and subsidies continue to place a heavy burden on the budget. Therefore, more restraint in excessive wage growth in the face of rising inflation rates, together with sharp declines in output and the gradual elimination of subsidies through phased price liberalization, will be necessary. On the revenue side, the projected collection and administration of the sophisticated value-added tax proves to be unrealistic in the initial phase of transition to a market economy, especially when public sector finances deteriorate

sharply. A simpler taxation system with a broad base, such as a sales tax, may well be suitable to Azerbaijan at this juncture.

I welcome the establishment of a two-tier banking system as an important step toward macroeconomic management. However, monetary policy cannot be effective under a dual currency system in the absence of a national currency as the sole legal tender and without an autonomous role for the central bank. The introduction of a national currency should be an urgent task for the Azerbaijan National Bank, following the virtual cessation of ruble issue by the Central Bank of Russia and the successful negotiation for Azerbaijan's withdrawal from the ruble area. The key to structural reform, however, lies in the privatization program. The realization of this program will be a slow process as long as domestic credit at negative interest rates to state-owned enterprises continues to grow at the 1992 pace, despite the continuing accumulation of the enterprises' arrears to banks and to other enterprises. Therefore, I urge the authorities to take the necessary measures to reverse this situation. With these comments, I can go along with the proposed decision.

Ms. Lindsay-Nanton made the following statement:

Like other FSU countries, Azerbaijan inherited large macroeconomic imbalances and serious structural weaknesses, including a collapsing command economy, inadequate legal and financial systems, and industrial and trade structures based on highly distorted relatives prices. In addition, there is a virtual absence of administrative institutions for economic policymaking, owing to the centralization of economic and political decision making under the former Soviet regime.

The authorities have put in place some measures to accelerate the transition to a market economy, and some progress has been made with respect to structural reforms, particularly in the financial sector and the legal framework. The authorities should be congratulated for these efforts.

However, I share many of the concerns expressed by other Directors. I regret the severe deterioration in the fiscal accounts of the state sector, which, having registered a surplus of 0.7 percent of GDP in the first three quarters of 1992, declined dramatically to a deficit of 4.2 percent by the end of the year.

The greater transparency in the budget structure is welcome, as noted in Mr Kaeser's opening statement. However, much of this deterioration came from the authorities' attempts to keep nominal wage growth in line with price developments as well as sharp increases in social assistance benefits. Some increase in nominal wages may have been justified, given the jump in prices and subsequent inflation rates. However, full indexation in the large state sector has exacerbated monetary instability and economic decline. Accordingly, what may be needed is a reduction in average real wages by reducing the extent of wage indexation to inflation.

The draft 1993 budget as presented is a cause for concern. Additional pressure comes from the fast-growing subsidies--notably on bread--as price adjustments fail to keep pace with cost increases, and the large deficit projected for the Social Protection Fund.

This situation is further complicated as the greater transparency in defense spending reveals the magnitude of financial resources that are being diverted to the conflict in Nagorno-Karabakh. Like previous speakers, I would underscore the importance of reaching a peaceful settlement in the not too distant future. Overall, budgetary developments will have to be monitored closely, with a view to restricting expenditure to the level of revenue-generated receipts and restricting recourse to bank credit.

The orderly adoption of the national currency, the manat, as the sole legal tender appears destined to be derailed. Increased uncertainty in the economic and political situation has been a contributing factor, although the staff notes that a move to the manat is effectively taking place. We agree with the staff that the national currency should be introduced in a deliberate manner with supporting financial policies and institutional reforms in place. I note that no decision had yet been taken on the choice of an appropriate exchange regime. We agree with the staff that, in the absence of comprehensive stabilization measures, a floating exchange rate for the Azeri currency initially would be appropriate.

It is also important for the Azerbaijan National Bank to assume an active role in monetary management, curtailing bank financing of the state budget and strictly curbing access by state-owned enterprises to bank credit. Close coordination of monetary and fiscal policy would be essential in order to support the manat.

The authorities have sought to recentralize export activities under the Ministry of Foreign Economic Relations. The trade system also distinguishes between strategic and nonstrategic products, with strategic products covering some 80 percent of exports. We view the recentralization of the trade and exchange systems as counterproductive and inconsistent with the transition to a market economy. While these measures may boost the Government's foreign exchange reserves in the short run, the recentralization of trade will discourage private export activity and foreign direct investment over the medium term. I note that the authorities view these export arrangements--the centralization of foreign trade--to be temporary but essential for the time being. I would be grateful for staff comments on the current export arrangements.

As other Directors have noted, Azerbaijan is well endowed with natural resources, including fertile agricultural land, minerals, oil, and natural gas. The authorities have committed themselves to transforming the economy to a market-oriented one. These efforts will have to be sustained, along with considerable further technical assistance and policy advice from the Fund and other multilateral agencies to assist in this process. I commend the authorities on their efforts so far at stabilization of the economy and wish them well in their future endeavors.

The staff representative from the European II Department recalled that, in its discussions with the authorities, the staff had made it clear that, under any exchange rate regime, it would be crucial to support the introduction of the national currency with appropriate policies aimed at reducing the rate of inflation and attaining price stability. Fiscal and monetary policies would need to be geared toward meeting this objective and securing the credibility of the national currency. While such policies would be essential regardless of the choice of the exchange rate regime, the staff had advocated a floating exchange rate for an initial period.

Following discussions with the authorities in December 1992, the staff assessment contained in the staff report indicated that Azerbaijan's economic performance had been relatively favorable in 1992, although certain serious underlying weaknesses remained, the staff representative said. In that context, the staff had encouraged the authorities to exercise caution in the period ahead, especially with respect to fiscal policy. The staff had stressed the need to introduce a restrained budget for 1993, to control the growth of domestic credit, to instill financial discipline in the enterprise sector, and to support such policies with a firm incomes policy. As Directors had noted, Azerbaijan's economic situation had deteriorated in the period between the circulation of the staff report and its supplement, indicating the need to move quickly in adopting corrective policies. It should be emphasized, however, that the underlying weaknesses were noted earlier by the staff and the authorities were cautioned.

With respect to sequencing of economic reforms, it was important to note that many of the policies were complementary, the staff representative continued. Therefore, it would be more effective to put the measures in place simultaneously, as a comprehensive adjustment package, rather than in a pre-established order. The staff had discussed the details of such a package with the authorities on several occasions. Moreover, a technical assistance mission from the Monetary and Exchange Affairs Department had left with the authorities, in February 1993, a fairly detailed action plan to modernize the central bank, strengthen the payments system, develop a foreign exchange market, and put in place policies to support the introduction of the national currency. It was conceivable that such a plan could be implemented simultaneously on several fronts within the next three to six months, thus forming a sound basis for the full move to the national currency.

While the authorities had indicated their intention to put in place in early 1993 the bankruptcy law, and other relevant legislation to support enterprise reforms, it was the staff's understanding that those laws had not yet come into effect.

The staff agreed with Directors that the current centralization of the trade and payments system, in particular, the multiple currency practice arising from the application of different implicit exchange rates for exports, the differentiation between strategic and nonstrategic goods, and the increased control of foreign trade represented a reversal of policy direction, the staff representative from the European II Department concluded. The staff had expressed its concern about the current policy trend to the authorities and had urged them to correct the present anomalies as quickly as possible. In that connection, the staff had emphasized that, with the introduction of the national currency, it would be crucial to decentralize trade and introduce a system that would allow exporters to receive market-related returns.

Mr. Kaeser made the following concluding remarks:

I would like to thank the Directors for the detailed discussion on the economic situation and policies of Azerbaijan. I will transmit to my Azeri authorities their encouragements as well as their comments and remarks. My colleagues, as well as the management and the staff, are concerned by the deterioration of the financial situation, which could become unsustainable if corrective actions are not introduced quite soon, including a better-designed and less expensive social safety net. Another matter of concern is the slowing down of the economic reform and the piecemeal approach to the introduction of the national currency. In this respect, an agreement between Azerbaijan and the Russian Federation warranting an orderly withdrawal from the ruble area is of utmost importance.

Directors recognize that the Azeri Government faces exceptionally difficult circumstances, which restrain its room for maneuver. Allow me to stress that, despite these adverse developments, Azerbaijan was eager to maintain an open dialogue with the Fund, notably for the Article IV consultation. Furthermore, the Azeri Government remains firmly committed to reform. This speaks clearly for a continuation of Fund technical assistance, which is urgently needed and for the stationing of resident experts in Baku.

Everybody shares the view that a peace agreement on Nagorno-Karabakh is the key to an economic take-off of both Azerbaijan and Armenia, as it would allow these countries to concentrate on a full-fledged economic reform. It is not the role of the Fund to take political initiatives. It shall limit itself to making an impartial assessment of the situation and to offering proper advice. Nevertheless, we hope that other international bodies and countries friendly to Azerbaijan and Armenia will help the belligerents come to terms.

Let me conclude by conveying the appreciation of the Azeri authorities for the staff, who worked with competence and dedication in the preparation of the staff report.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff appraisal. Directors recognized that Azerbaijan's economic performance over the recent period had been adversely affected by dislocations stemming from the breakup of the Soviet Union and the intensification of the conflict over Nagorno-Karabakh, which absorbed considerable human and financial resources. Against this background, Directors commended the authorities for initiating measures to introduce market-based economic structures, and noted some of the relatively favorable developments in Azerbaijan compared with some neighboring countries. At the same time, Directors expressed their concern about the more recent deterioration, particularly in budgetary performance.

Directors noted--and, indeed, many welcomed--Azerbaijan's intention to introduce a national currency and stressed the importance of having the requisite supporting policies in place. In that connection, several speakers were concerned that the fiscal policies presently envisaged for 1993 did not provide adequate assurance that the budget deficit can be sufficiently contained to ensure financial stability. Directors expressed the view that the policy of maintaining and, in certain cases, raising real wages and nontargeted social benefit payments was too costly and could not be sustained in the face of a sharp decline in output and in the absence of compensating expenditure cuts. Directors emphasized the importance of monitoring budgetary developments closely. While recognizing that both revenue and expenditure had been rising, they emphasized that the authorities should concentrate on curtailing expenditures and narrowly limiting government recourse to bank credit. Better targeting of social benefit payments, for example, would help restrain overall expenditures.

Directors noted that the sharp growth in domestic bank credit during 1992 had mostly accommodated the financing needs of state-owned enterprises. They stressed that it would be crucial to instill financial discipline in state-owned enterprises by considerably hardening their budget constraints. The recent passage of the privatization law was welcomed, and progress was urged in restructuring the enterprises remaining under state control and implementing a privatization program for 1993. Directors expressed the hope that these efforts, as well as implementation of land reform, would proceed without delay.

Directors observed that the passage of banking laws had set the ground for the Azerbaijan National Bank to function as an independent central bank and focus its attention on its primary responsibility, monetary management. Once Azerbaijan introduced its national currency, the authorities would need to direct monetary policy firmly toward the objective of reducing the rate of inflation. Several speakers urged the authorities to raise interest rates to positive real levels in the context of the monetary and credit program for 1993. The authorities should move forward with reforms of the banking system, strengthening banking supervision and developing the basis for more active use of market-based monetary policy instruments. It was suggested that direct controls over credit creation would need to be utilized until indirect means of credit control were developed.

The large negative residual in Azerbaijan's balance of payments suggested a growth in funds held abroad. The reversal of such flows could best be achieved through an active interest rate policy, combined with a simplified and decentralized exchange and external trade system that would ensure market-related returns to exporters.

Directors noted that, with the move to the national currency, a decision would need to be made on an appropriate exchange regime. Given the prospects for far-reaching structural changes in the economy and the need to progress toward full current account convertibility, most Directors believed that a flexible regime would be necessary, at least until greater price stability was achieved. Measures to develop Azerbaijan's foreign exchange market would facilitate this process. Directors observed that, under either a fixed or flexible system, it would be essential to adopt appropriately restrictive fiscal and monetary policies so as to limit inflationary pressures and promote confidence in the national currency.

Directors welcomed Azerbaijan's progress to date with tax reform and price liberalization, and underscored the urgent need to sustain the momentum of systemic reforms, including further price liberalization, in the transition to a market economy. In particular, the need to expose state-owned enterprises to market conditions called for putting in place the legal and institutional framework that would be necessary to clarify ownership rights, contract arrangements, and bankruptcy procedures. Directors stressed that the resolute implementation of structural reforms, together with success in attaining macroeconomic stability, would provide the best assurance for the resumption of sustainable growth in Azerbaijan. They hoped that the efforts to resolve the conflict over Nagorno-Karabakh would be successful, as this would facilitate implementation of the Government's reform program and help attract the foreign capital needed for Azerbaijan to develop its natural resources and realize its growth potential.

Directors emphasized the importance of maintaining a close dialogue with the Fund and expressed their support for the provision of technical assistance, including the stationing of resident experts.

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

The Executive Board took the following decision:

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

2. Azerbaijan's restrictions on payments and transfers for current international transactions, described in SM/93/51, are maintained in accordance with Article XIV, Section 2. The Fund encourages Azerbaijan to remove these restrictions.

Decision No. 10318-(93/38), adopted
March 22, 1993

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/37 (3/18/93) and EBM/93/38 (3/22/93).

3. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

The review of Somalia's overdue financial obligations to the Fund provided for under paragraph 5 of Decision No. 9575-(90/154), adopted October 26, 1990, as amended, is postponed to a date to be determined by the Managing Director, when in his judgment there is once again a basis for evaluating Somalia's financial and economic situation, the stance of economic policies, and its cooperation with the Fund, and in any event not later than September 20, 1993. (EBS/93/41, 3/15/93)

Decision No. 10319-(93/38), adopted
March 18, 1993

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/91 through 92/94 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/93/49 (3/17/93) is approved.

APPROVED: November 1, 1993

LEO VAN HOUTVEN
Secretary