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Minutes of Executive Board Meeting 92/137

10:00 a.m., November 16, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	A. Raza, Temporary
	Duan J., Temporary
	Q. M. Krosby
	M. E. Hansen, Temporary
J. de Groote	J. Prader
E. A. Evans	A. M. Tetangco, Jr.
	A. Giustiniani, Temporary
	S. Vori, Temporary
I. Fridriksson	J. A. Solheim
	N. Tabata
	T. Kanada, Temporary
	B. Esdar
J. E. Ismael	K.-T. Hetrakul
D. Kaeser	
	P. Rubianes, Temporary
K. G. Kagalovsky	A. V. Mozhin
	G. Y. Glazkov, Temporary
	I. Martel
R. Marino	
	H. Golriz, Temporary
L. J. Mwananshiku	B. S. Dlamini
	J. Dorrington
	R. Thorne, Temporary
G. A. Posthumus	
	A. R. Ismael, Temporary
A. S. Shaalan	Y. Y. Mohammed
	G. F. Murphy
	J. Jamnik, Temporary
A. G. Zoccali	

J. W. Lang, Acting Secretary
C. P. Clarke, Assistant

<u>Also Present</u>
IBRD: F. D. Levy and M. Noel, Europe and Central Asia Regional Office. European I Department: J. R. Artus, Deputy Director; G. Bélanger, E. V. Clifton, L. J. Lipschitz, A. Singh, T. van der Willigen, R. van Elkan, C. M. Watson, N. E. Weerasinghe. External Relations Department: M. A. Seeger. Fiscal Affairs Department: E. F. Offerdal. Legal Department: P. L. Francotte. Monetary and Exchange Affairs Department: S. P. Leite. Policy Development and Review Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; D. Burton, S. Ishii, G. R. Kincaid, S. T. Phillips, E. van der Mensbrugghe. Research Department: J. Baras, M. S. Khan. Secretary's Department: A. Jbili. Treasurer's Department: L. U. Ecevit, G. S. Tavlas. Personal Assistant to the Managing Director: R. Saunders. Advisors to Executive Directors: P. Bonzom, L. E. Breuer, R. F. Cippa, B. R. Fuleihan, Hon C.-W., W. Laux, R. Meron, L. M. Piantini, B. Szombati, A. Törnqvist. Assistants to Executive Directors: B. Abdullah, T. Berrihun, M. Blome, J. M. Burdiel, Deng H., A. Galicia, K. M. Heinonen, O. A. Himani, J. Jonas, K. J. Langdon, G. J. Matthews, S. McDougall, M. V. Nikitenko, M. L. Tase, T. P. Thomas, A. Viirg.

1. CZECH AND SLOVAK FEDERAL REPUBLIC - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the review under the 12-month stand-by arrangement for the Czech and Slovak Federal Republic approved on April 3, 1992 (EBS/92/162, 10/14/92).

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

> The political situation in Czechoslovakia is dominated by preparations for the dissolution of the federation. The constitutional mechanisms for achieving this are complicated and not entirely clear. Nevertheless, both Governments--Czech and Slovak--remain committed to dissolving the federation on January 1, 1993. The two Governments have signed agreements on a post-dissolution customs union and a monetary arrangement. The latter provides, initially, for a single currency with two separate central banks operating monetary policy through a joint monetary committee.
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> While economic performance in the country as a whole continues to be quite good--all performance criteria under the stand-by arrangement through September 1992 have been respected--impending dissolution has focused attention on regional differences. In this connection, the staff has some qualms about post-dissolution monetary arrangements and the economic and financial circumstances of, in particular, Slovakia.
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> First, the starting position of Slovak enterprises is weaker than that in the Czech lands. Unemployment is already about 11 percent--compared with under 3 percent in the Czech lands--and problems of enterprise governance are likely to assume increasing importance.
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> Second, the fiscal situation in 1993 could be particularly difficult in Slovakia. The budgetary imbalances that have emerged this year and the loss of sizable fiscal transfers from the Czech lands next year point to a substantial widening of the deficit.
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> Third, the cessation of fiscal transfers from the Czech lands and a less smooth interregional intermediation of savings will also exert a negative influence on the Slovak balance of payments.
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> In the last few months, the financial markets in Czechoslovakia have become increasingly segmented. Czech institutions are reluctant to lend to Slovak institutions or to buy Slovak Government debt, and, in general, the intermediation of Czech savings to Slovak borrowers has been disrupted. Moreover, it appears that the normal--private sector--Slovak payments deficit with the Czech lands is being widened by interregional

capital movements in anticipation of new exchange arrangements. In this light, the staff is concerned that the single currency post-dissolution arrangement might prove untenable. The staff is encouraging the authorities to accelerate preparations for fully operational central banks in both republics, capable of managing their own currencies. In the meantime, it is essential that policy actions and pronouncements be aimed at quieting fears on this score.

The tenability of a single currency arrangement--and, indeed, the integrity of any new Slovak currency--will depend on fiscal policy, income policy, and the willingness to allow divergences in interest rates between the two states. Fiscal and financial viability will require that real wages be curtailed and that enterprises be restructured with limited fiscal support. On fiscal policy, the scope for revenue measures will be circumscribed by the customs union with the Czech lands and limits on the extent to which tax rates can be differentiated. It is likely, therefore, that the authorities will need to make substantial cuts in expenditure.

A staff visit to Slovakia to discuss the macroeconomic strategy and to begin to compile the data necessary for a proper analysis of the situation will be leaving this evening.

Mr. de Groote made the following statement:

It is exceptional to be reviewing the performance under a stand-by arrangement of a country that within six weeks will cease to exist. Starting on January 1, 1993, 74 years after coming into existence, Czechoslovakia will separate peacefully into two independent states. The uncertainties connected with this partition will be compounded by the difficulties connected with economic reforms and external shocks. However, the two new republics will remain more closely interdependent than is generally assumed; for example, approximately one third of the sales of Slovak industrial firms is directed to the Czech lands, while about one sixth of the sales of all Czech enterprises is delivered to Slovakia. This close integration is being further reinforced by the establishment of a customs union between the two republics.

The staff has succeeded in distilling into eight brief pages a precise analysis of the recent economic developments and the current situation in Czechoslovakia. My authorities might cavil that the staff estimate of the end-1992 budget deficit is a bit pessimistic, but the staff's slight bias toward pessimism is neither surprising nor undesirable. Much more important than whether the deficit will be 4 or 4.5 percent of GDP is the Government's absolute determination to reduce spending as needed to offset the revenue shortfalls. In other words, the deficit will remain manageable despite the inevitable structural and cyclic pressures during the transition period. Neither the Czech nor the Slovak authorities are complacent about this, and both are ready to keep their budgets balanced in 1993.

Czechoslovakia's experience over the past two years shows that the widespread pessimism about the outcome of the country's nongradualist transition was mistaken. Czechoslovakia's shock therapy succeeded because the prerequisites for success were present; monetary and fiscal policy had been rigorously implemented before the political changes occurred. In the months after the political change, Czechoslovakia was the only one of the transition countries to react by further tightening these policies instead of relaxing them. Most large Czechoslovak enterprises had already become accustomed to a high degree of management autonomy before the political change, while between the Velvet Revolution and the adoption of a Fund-monitored program at the beginning of 1991, the Government swept away the former system to make way for the legal and institutional changes needed for a market economy to function.

From the outset, the program we are reviewing today was not, as in other cases, a stabilization program, because there were no large macroeconomic imbalances needing correction. Czechoslovakia had only to obtain the liquidity needed to defend the liberalization of foreign trade and payments during its critical initial stage. The success of the program in terms of the transition to a market economy has met or exceeded expectations. If account is taken of the income and trade effects of the collapse of Council for Mutual Economic Assistance (CMEA) relations, the transition to a market economy has occurred at minimal cost. In the country's financially stable environment, the privatization and institutional changes are bound to elicit a strong positive supply response. These effects will be more rapid in the Czech republic and slower in the Slovak republic, because of the need in Slovakia to rehabilitate or replace large industrial entities producing goods for which there is no longer extensive demand.

The partition of the country makes it hard to attempt any economic projection beyond the end of this year. While it is generally agreed that any negative effects of the partition will bear more heavily on the Slovak economy, the actual extent of the damage will depend greatly on what policies the sovereign Slovak Government will pursue.

For the Federal Republic, the economic agenda until the end of the year is crowded, calling for passage of the law on securities and the law on social funds, and completion of the first wave of large-scale privatizations. To these are now added countermeasures against disruption owing to the partition, most importantly the agreement on the customs union and the agreement on monetary arrangements.

The customs union between the two new republics serves two purposes: first, it will smooth the transfer to the successor republics of Czechoslovakia's membership in the GATT and its Association with the European Community; and second, it will preserve for the two new republics a common economic space, providing free movement of goods and services and promoting coordination of economic policies.

A more complicated aspect of the "velvet divorce" will be designing a monetary arrangement to protect the real economy against disruption by excessive speculative flows. The future currency arrangement will be established in three stages. During Phase One, beginning January 1, 1993, the two republics will still have a common currency. Six months later, as presently planned, Phase Two will begin with formal separation of the koruna into two currencies, initially related by a fixed exchange rate. Phase Three will begin whenever development of the real economies and differences in economic policies make it possible to consider, if needed, a divergence in the exchange rates of the two currencies.

During Phase One, there will be close coordination of monetary policies between the Czech republic and the Slovak republic. For some time after the Slovak National Bank begins its official existence on January 1, 1993, its ability to conduct an independent monetary policy will remain limited. To prevent disruptive divergences and ensure consistency with the temporary preservation of a single currency, the Agreement on Monetary Arrangements provides for monetary policies to be guided by a joint committee consisting of the governors of both central banks and two deputies for each governor. The Monetary Committee will have jurisdiction over the issue of bank notes and coins, the amount and conditions of credit provided to the Governments, the liquidity and capital adequacy rules for the commercial banks, and the exchange rate of the common currency. By the end of 1992, each republic will have adopted new laws governing its central bank.

Besides the agreements on the customs union and monetary arrangements, the two Governments have signed over 15 other agreements regulating their future relations, one of the most important governing the mobility of labor. These agreements have still to be ratified by the two Parliaments. The two Governments have also agreed on simultaneous implementation of the comprehensive tax reforms originally designed for the Federal Republic as a whole. These reforms will become effective in both republics on January 1, 1993.

Although the policies to be followed in the Czech and Slovak republics may differ, each will find renewed confidence in its new freedom to pursue its own interests. The Czech authorities will be able to pursue their own reform agenda without accounting for policy differences with Slovakia. Slovakia, for its part, has to overcome high unemployment and rehabilitate its industry. Some observers believe, therefore, that Slovakia's reform efforts will stall after the separation, but I am confident from my conversations with the Slovak leadership that they will follow policies that are more and not less strongly oriented toward reform once it is clearly perceived that these policies are, indeed, Slovakia's own and are not "imposed" by a federal government.

All in all, the partition of Czechoslovakia by mutual agreement and its accomplishment in a constitutional and civilized manner are making it easier to avoid major economic damage. The media have approached this unusual process with their usual expectation of finding negatives in novelty. Their pessimism owes more to habit than to observation. I am confident that the strong desire of both republics to continue their close economic relationship will favor the continuation of the striking success they have achieved up to now in their transition to market mechanisms.

Mrs. Hansen made the following statement:

Mr. de Groote began his statement with a comment on the oddity of appearing to conduct a normal program review for a country on the verge of dissolution. It does seem peculiar, in a way, to dwell on the past performance of a country that will soon cease to exist, especially when most observers are trying to look into the future for clues about economic consequences of the "velvet divorce." Be that as it may, the review does provide some interesting food for thought about the challenges ahead and the policies that have worked so far.

One conclusion that may be drawn is that the federal authorities have managed the economy reasonably well in the first half of 1992 and, in so doing, have placed each republic in a better position to begin its independence on January 1, 1993.

Rigorous monetary and fiscal policies have resulted in greater price stability than programmed, with the result that inflation for the year may be contained to a single-digit level. If so, Czechoslovakia will be the first economy in transition to achieve this degree of price stability. At the same time, it appears that strong macroeconomic policies, combined with rapid structural change, especially privatization, have provided the ingredients for GDP growth--at least on a fourth-quarter to fourth-quarter basis--for the first time since Czechoslovakia began its economic transformation. These same policies have induced a reorientation of exports toward the West, resulting in a stronger than envisioned current account and a significant increase in reserves. Both republics will benefit from these achievements at independence.

At the same time, however, the budgetary strains that have recently begun to appear at the federal level point to important fiscal challenges for the two republics in 1993. When the current stand-by arrangement was approved in April 1992, the staff was projecting a 1993 deficit on the order of 5.5 percent of GDP, following a deficit of 3 percent in 1992. Now, with the 1992 budget deficit projected at about 4 to 4.5 percent of GDP and no doubt new, but as yet unquantified, costs associated with "the divorce," the outlook for 1993 is probably also bleaker than indicated earlier, unless stronger policies are adopted to offset increased spending pressures and possible revenue shortfalls stemming from tax reform and other factors.

In our view, the first policy priority for each republic should be to adopt policies that clearly reaffirm each republic's commitment to macroeconomic stability and rapid structural reform. This will help ensure continued inflows of private and multilateral credit and discourage possible capital flight. The key element, of course, will be strong fiscal policies that keep republican budgets as close to balance as possible and, in any event, at levels that can be financed without excessive reliance on bank financing. Inevitably, this will place a greater burden on the Slovak republic, where the economy seems slacker, unemployment is higher, and the need for industrial restructuring is greater. This being the case, however, Slovakia would also appear to have a greater need for both foreign capital inflows to modernize the economy, provide new employment, and stimulate economic growth, as well as convincing policies to attract this new capital and investment.

Mr. de Groote's statement provides some interesting information on the monetary arrangements worked out between the two republics. We hope that close monetary coordination envisaged during Phase One of the currency arrangement will run smoothly and that the two republics will move quickly to ensure that the new Slovak National Bank becomes fully equipped to conduct monetary policy as soon as possible. No doubt the Fund is also planning technical assistance in this area, and it would be interesting to learn what these plans are. We are certainly not in a position to prejudge how long Phase Two of the currency arrangement--in which two separate currencies trade at a fixed exchange rate--will last. But we hope that the two Governments will use the six months of Phase One to establish strong policies and, thereafter, that they will approach Phase Two pragmatically.

With regard to the Fund's future relations with Czechoslovakia and its constituent parts, it would be helpful if the staff could shed some light on how the institution plans to proceed from here. The statement in the staff paper to the effect that the Czechoslovak authorities do not intend to make the final two purchases in light of the strength of reserves seems to imply that they would, nevertheless, continue to be eligible to draw on the Fund after dissolution. Perhaps the staff could clarify when and how the stand-by arrangement will be terminated and provide any indications it may have at this time about the likely timing of the Board's consideration of the change in membership from one member to two.

With these brief remarks, we commend the federal authorities for their performance under the stand-by arrangement and wish the two republics well in the final stages of their transition to independence.

Mr. Tabata made the following statement:

The economic performance of Czechoslovakia has been far better than we expected, and its transition to a market economy has been smooth. Production is increasing, inflation has calmed down, and the unemployment rate has declined. In addition, I welcome the fact that all of the performance criteria for end-September were met.

I think it is, indeed, a matter of great accomplishment that the authorities do not need to purchase the remaining amount under the current stand-by program because of their favorable balance of payments situation, stemming mainly from a steady increase in manufactured goods to the EC countries. At this juncture, I was surprised by the fact that the EC has imposed quantitative restrictions on the import of steel products from Czechoslovakia. The EC countries should not act the role of bully.

Regarding the implementation of monetary policy, I appreciate the authorities' prudence in reducing the target for net domestic assets and raising domestic interest rates in order to cope with the excess liquidity caused by a balance of payments surplus.

On the structural front, it is also welcome that privatization has progressed substantially, interenterprise debt has been reduced markedly without any specific intervention by the Government, and bank supervision has been strengthened.

In this favorable economic situation, the only concern is an expansion of the fiscal deficit. In particular, the lower than expected government revenue is a cause for concern. This being said, I appreciate the fact that the authorities have already raised the consumption tax on petroleum products and have decided to cut current expenditures. However, these measures seem to have only a temporary effect on the current fiscal problems. It is imperative to improve tax administration. In this context, I believe that the Fund's technical assistance will clearly contribute to its improvement.

Finally, I would like to touch briefly upon the projected problems relating to the planned division of the country. As the official debt of the federal Government is said to be small, there is unlikely to be a serious dispute between the two independent countries on the succession of debt and assets. However, to establish monetary policy coordination under a single currency system and to build up an efficient payments system would appear to be far more difficult. These are, nevertheless, extremely important tasks. The difference in industrial structure between the two countries might provoke uneven short-term capital movements between the two countries and between them and third countries. In that case, it will be necessary to implement coordinated actions by the two central banks of the Czech and Slovak republics. In order to cope with this situation, it is urgent to establish effective and practical monetary arrangements immediately. In this context, I felt reassured by the fact mentioned in Mr. de Groote's informative statement that the general framework of expected monetary coordination has been built. In any event, cautious preparation for the planned division of the federation is extremely important for the maintenance of economic stability in the two countries. I strongly expect that the planned division will be executed prudently and successfully.

With these comments, I support the proposed decision.

Mr. Posthumus made the following statement:

This review under the stand-by arrangement for Czechoslovakia might have been uneventful if we had not known that within a few weeks Czechoslovakia will break up into two countries. All of the performance criteria have been met, and the authorities have decided not to make the remaining purchases under the stand-by arrangement in view of the strength of the balance of payments, a decision that I find very commendable and that also shows the guiding hand of Mr. de Groote. In the absence of the impending dissolution, the only thing the Board would have had to do is stress the importance of keeping the fiscal balance under control--or rather, of repairing the imbalance--particularly in 1993.

Unavoidably, however, the impending dissolution of Czechoslovakia focuses our attention on this issue, even though this is strictly not an element of the stand-by arrangement. At the outset, however, I would support Mr. de Groote's conclusion that the preparations for the dissolution are clearly taking place in such a way that they have not disrupted economic policy in 1992, and the progress under the stand-by arrangement bears witness to this. This is a big achievement.

Nevertheless, I would like to explore some of the issues of the post-stand-by arrangement period, and I would welcome the reactions of the staff and Mr. de Groote to these observations. The monetary and exchange arrangements between the two states will be vital for further developments. The strain in the conduct of fiscal policy requires attention, in particular in the early phases of the monetary arrangement that Mr. de Groote describes. We have seen in the exchange rate mechanism of the European Monetary System (EMS) that fiscal imbalances pose a threat to fixed exchange rate regimes, or de facto fixed exchange rate regimes. Fiscal imbalances in the Slovak republic may well grow faster than in the Czech republic, leading to speculative flows. The occurrence of such flows may have led to the limits that Czech banks have imposed on their exposure to Slovakia. Is the increasing trend in foreign currency deposits not also an indication of such speculative flows?

All of this may mean that Phase Three of the monetary arrangement would have to be introduced rather soon, causing something like the disruption that we see in the ruble area--even though cooperation between the Czech and Slovak authorities is clearly better than cooperation in the ruble area. The Board could stress today that keeping the fiscal balance under control in 1993 in both new republics is even more urgent than usual, and that slippages will have more detrimental effects when two countries have one currency, or fixed exchange rates, than would be the case when there is only one budget. There is a role for the Fund, whether in the framework of the Article IV surveillance or in the form of stand-by arrangement conditionality.

Czechoslovakia should provide a good example of how to handle the dissolution of a country, although I think that the good example should not be followed by more countries, just as the bad example of other dissolving countries should not be followed.

Mrs. Martel made the following statement:

As other speakers have said, Czechoslovakia is going to be divided. This does not mean, however, that we do not have to take stock of the progress achieved by Czechoslovakia, which is impressive and remarkable. The example of Czechoslovakia's stabilization success has shown that a centrally planned economy with limited macroeconomic imbalances can overcome the effects of a large price liberalization and severe terms of trade shock while keeping inflation under control and without a deterioration of the current account.

Prices have shown a spectacular pattern since the large jump in prices in 1991; they have decelerated significantly and inflation is now below program projections. The external results are better than expected. The successful reorientation of exports is at hand. The key to this success was a combination of tight fiscal and monetary policies, as well as a stable exchange rate policy.

What strikes me most at the present time is the situation regarding output. Real GDP was projected to be flat through 1992, and it now seems set to increase. Staff projections foresee real GDP growth of 3-4 percent through the year. This development follows the large decline in economic activity in 1991. As in other reforming economies of Eastern Europe, GDP effectively fell sharply in the first year of the stabilization reform program by about 17 percent in 1991. Apart from the cessation of activities that were no longer competitive under the new rules of the game, several factors were at play, including the large increases in the relative price of energy and other industrial inputs, the declining export demand from other previously centrally planned economies, and the fairly tight policy stance adopted by the authorities to prevent an inflationary spiral.

I understand from the staff paper that there has been a slight increase in industrial production and much stronger growth in the construction and services sectors. There now seems to be a larger differentiation in the response of specific sectors, especially services. Perhaps the staff could comment on this observation.

In any case, it is clear that the economy is at a turning point, and the results attained so far are very impressive and encouraging. In this regard, the conduct of monetary policy, which allows room for credit to the nongovernment sector, with the commitment that any additional financing required by the Government will come from nonbank sources at market-determined rates of interest, seems very much appropriate. Indeed, I agree with the staff that the conduct of monetary policy in 1993 could prove difficult, should price pressures arising from the introduction of the value-added tax (VAT) and from wage demands materialize. In this context, I would welcome some comments from the staff on the intention of the authorities for 1993 as far as incomes policy is concerned.

On fiscal policy, I agree with the staff that there are challenges facing the authorities, the main problem coming from the erosion of tax revenues. The overhaul of the tax system, based on the introduction of the VAT and the modernization of corporate and personal income taxes, is a very significant improvement. The introduction of these measures, however, especially the VAT, requires the development of a tax administration oriented toward collecting revenues from a much larger number of individuals and firms than under the previous system. Nevertheless, I am reassured by "the Government's absolute determination to reduce spending as needed to offset the revenue shortfalls," as stated in Mr. de Groote's opening statement.

On structural issues, the progress made in privatization is commendable. I very much welcome the steps taken on the institutional and regulatory framework for transactions in distributed shares, and also the putting in place of regulatory offices to avoid irregularities in or mismanagement of investment privatization funds (IPFs). Some IPFs have followed aggressive market strategies and have guaranteed returns that may be difficult to materialize. There are some risks that the financial collapses of aggressive IPFs could spill over to the banking system if both systems are not carefully separated. Clearly, this process has to be monitored closely.

With respect to the commercial banks, there remain uncertainties about the quality of their portfolios. There is a large and uncertain stock of bad debts, and, in order to prevent this stock from continuing to increase, it is essential that the banks should be in a position to make judgments on lending and provisioning on as commercial a basis as possible.

I understand that bonds issued by the National Property Funds have been transferred to the commercial banks, part of the amount being earmarked for capitalization of the banks, the rest being used to compensate banks for writing off loans of certain enterprises. These actions are welcome but, as the staff points out, may not totally solve the whole issue.

Finally, I must say that the results attained by Czechoslovakia have been impressive and are very encouraging. It is clear that the partition of the country is going to create great uncertainties; in order to keep the cost of this partition as low as possible, the two interdependent economies must maintain the existing links through appropriate trade and exchange arrangements. Mr. de Groote's statement is very reassuring in this regard.

I support the proposed decision.

Mr. Giustiniani made the following statement:

During the first part of the ongoing program, remarkable results have been achieved by the Czechoslovak Government, notwithstanding the complications arising from the imminent dissolution of the federation. All of the performance criteria have been fulfilled. There is some evidence that the decline in economic activity, after the negative result in the first half of 1992, is about to taper off. Inflation has been brought down significantly, although a slight reversal of the trend was recorded in July and August. The redirection of trade away from the former CMEA markets has continued, and both the trade balance and the current account have improved compared with the program projections, bringing about a significant strengthening of international reserves. The bold mass privatization process through the voucher scheme seems to have proceeded smoothly, despite the high degree of uncertainty and potential financial irregularities surrounding it.

However, notwithstanding these encouraging achievements, the process of macroeconomic stabilization still seems to be exposed to latent risks, even without taking into account the planned division of the country. Therefore, we cannot but welcome the federal authorities' intention to continue the arrangement as a comprehensive framework for steering and monitoring their economic policy, even though they do not intend to make the remaining purchases in light of the sound balance of payments position.

Risks arise mainly in the budget area, where, in addition to emerging evidence of an early breakdown of fiscal coordination between the federal and the republican Governments, the ongoing growth of private sector activities has increased the confrontational nature of tax collection as well as the phenomena of tax avoidance and evasion. This emphasizes the need to strengthen and make more efficient the tax administration structure--a need that is reinforced in the light of the tax reform planned for January 1993. In this regard, because a new tax system, as we know, can hardly be expected to be revenue increasing or even revenue neutral, firm monitoring of expenditure developments will be required in order to avoid a further deterioration of the budget deficit, which could hamper the process of macroeconomic stabilization. Such a conservative attitude toward fiscal policy becomes even more crucial when we consider that major structural adjustments in the enterprise sector are still to come. In fact, although unemployment edged down in the first half of the year--partially as a result of a tightening of registration criteria--large-scale labor shedding seems unavoidable, particularly in large state enterprises, to improve the competitiveness and profitability of enterprises, as a further significant cut in real wages might be less feasible politically. Therefore, in a context of potentially falling revenues, additional pressures on safety net expenditures and unemployment compensation could, ceteris paribus, undermine the soundness of public finances.

On the monetary front, this chair cannot but commend the federal authorities for having pursued a firm stance of monetary policy, thus preventing the injection of liquidity through the balance of payments from rekindling inflationary pressures. We encourage the authorities to maintain that policy stance in the coming months, given the potential risk of price tensions arising from the introduction of the VAT and the likely ending of tax-based incomes policy for privatized firms. In addition, we would like to express our concern about the rapid growth of the credit aggregates, which could jeopardize the achievement of stable monetary conditions. At this juncture, when the role and the structure of the financial markets are evolving, it is also crucial that financial intermediaries be prevented from performing questionable practices that could undermine market stability, already made fragile by the inherited bad loans. Therefore, this chair cannot but welcome the adoption of measures aiming at strengthening the prudential supervision of the banking system and the IPFs.

Finally, let me express the hope of this chair for a prompt ratification by both the Czech and Slovak Parliaments of the agreements signed at the end of October 1992, which define the post-partition relations between the two republics and, more generally, the framework for enduring cooperation between the Czech and Slovak Governments in order to prevent the dissolution of their federation from upsetting the ongoing process of structural reform and macroeconomic stabilization.

With these comments, this chair supports the proposed decision.

Mr. Dorrington made the following statement:

Let me join other speakers in congratulating the Czechoslovak authorities on their impressive performance. Indeed, in many respects, this can be regarded as a model example of a stand-by arrangement. The authorities recognize the difference between ceilings and targets, and the arrangement can be thought of as a true "stand-by," with the authorities gaining the benefit of the policy discipline and credibility but not automatically expecting to draw the resources. I endorse Mr. Posthumus's comments on this point.

The one area of slight slippage has been fiscal policy, with emerging tax administration problems and lack of full coordination between federal and republic authorities. Tax administration will need to be pursued vigorously--especially in Slovakia, given the ending of federal transfers. Meanwhile, it is encouraging that steps have already been taken on the spending side.

Steady structural progress continues to be made. Continued monetary reform has been particularly encouraging, and I welcome the removal of direct credit controls, the development of a nonbank government debt market, which should help to avoid the monetization of budget deficits, and the efforts to strengthen banking supervision. It is also particularly pleasing to see inflation brought down to single figures at the same time as the price level is being given upward shocks by the removal of subsidies. However, I share the staff's concern about the delays in implementing bankruptcy legislation. This is an essential step in reforming the economy, and delay can only increase the inevitable difficulties.

Meanwhile, the privatization process appears to be going as smoothly as one would expect. Of course, as the paper notes, the authorities' earlier plans may be modified after partition; as the full benefits of privatization, in terms of greater efficiency, resources allocation, and corporate governance, can only follow the development of a secondary market in shares, I welcome the progress in this area.

On the exchange rate, the fixed rate appears to continue to serve the authorities well. The current account, inflation, and real wage developments all suggest that the competitive position is a strong one. Perhaps in these circumstances, and given the weaker than expected import levels, the authorities--present or future--could give thought to the room for eliminating the import surcharge.

Looking to the future, the uncertainties following partition are, of course, immense. It is crucial that coordination between the two republics be as close as possible to avoid unnecessary disruption and a loss of confidence both domestically and abroad. The good relations and spirit of cooperation that exist should serve the authorities well; and Mr. de Groote's statement and the staff representative's comments note several welcome developments.

As has already been said, the Slovak authorities face the greater task, because they will have less of the machinery of government already in place, and too much machinery capable only of producing goods for which the market has disappeared. It is already evident that Slovak debt is trading at a discount to equivalent Czech paper, illustrating market concerns. I understand that the Fund is making a particular effort in technical assistance to Slovakia, and a mission is going there soon. I welcome this and would like to hear more about the Fund's role in this process. Like Mrs. Hansen, I would also welcome the staff's comments on the arrangements for dealing with Fund membership of the two republics. In that context, I hope that both the authorities and the staff do everything possible to ensure smooth and immediate Fund membership for the republics at the time of partition.

With these comments, and despite the extraordinary circumstances and inevitable uncertainties, I have no hesitation in supporting the proposed decision.

The staff representative from the European I Department said that it was the staff's understanding that the Czech and Slovak Federal Republic would cease to exist on January 1, 1993. The stand-by arrangement for Czechoslovakia, which had been scheduled to extend through early April 1993, would lapse upon the dissolution of the federation; at that stage, the staff would begin formal discussions with both the Czech and Slovak authorities on possible follow-up arrangements for the successor states. On the issue of membership, the authorities' preference was to succeed jointly and simultaneously to Czechoslovakia's membership in the Fund. Within the past few days, the authorities had provided the staff with a great deal of the data that were needed for making quota calculations.

Technical assistance from the Fund had, indeed, assumed a much greater urgency, especially in the area of monetary and exchange arrangements, the staff representative remarked. A mission from the Monetary and Exchange Affairs Department would be going to Slovakia in December 1992 with a view to setting up a team to help with the establishment of the Slovak central bank. In both republics, the Fund had provided a great deal of technical assistance on the introduction of the VAT and the preparations for the new tax system, which had been highly appreciated by the authorities and would be continued. Further technical assistance would also be provided to both republics in the important, but slightly less urgent, areas of tax administration and expenditure control.

The staff did not believe that the increase in foreign exchange deposits, which Mr. Posthumus had noted, was indicative of speculative capital flows, the staff representative stated. There had been an upward trend in the proportion of foreign exchange deposits in broad money, which had increased from 5 percent at the end of 1990, to 7 percent at the end of 1991, and to about 9 percent currently, but that increase was more or less matched by the opening of the economy. The earlier fluctuations in the informal koruna market in Vienna, which might have been indicative of speculative flows, had largely diminished.

The structure of the recovery of output, especially in the Czech republic, was interesting in several respects, the staff representative considered. As Mrs. Martel had observed, construction, retail sales, and services were the leading sectors of the recovery. Moreover, there was a much greater degree of differentiation in the recovery of the manufacturing sector than had been the case with the fall in output in 1991. The switch-over of production that was currently taking place was especially interesting; some of the old enterprises were closing down parts of their operations, which was being more or less matched by burgeoning new small private sector companies. One of the indicators of the extent of that process was the very high ratio of vacancies to unemployment; indeed, vacancies in the Czech republic were equivalent to almost 70 percent of the republic's unemployment. There was, therefore, a buoyant demand for labor in those new sectors, which was a promising sign.

With respect to incomes policy, the staff representative from the European I Department remarked, it was clear that there would almost certainly not be a formal incomes policy for the private sector in the Czech republic following independence. Some continuation of the tax-based incomes policy for the public sector enterprises could be expected, however. In Slovakia, the staff had discussed the matter briefly with the authorities a few months previously, but they were still formulating their position; the staff would certainly continue those discussions during the forthcoming mission.

The staff representative from the Legal Department said that he could confirm that the stand-by arrangement for Czechoslovakia would lapse upon the dissolution of the country. On membership issues, the staff was, indeed, trying to ensure a smooth transition from the membership of Czechoslovakia to the membership of the successor states. There was a strong consensus among the federal and republican authorities that the succession approach to membership was the best approach, even though it would not have the financial implications that existed for Yugoslavia, for example, because no SDRs had been allocated to Czechoslovakia and it had not been a member of the Fund in 1975, and, therefore, there would be no issue of possible capital gains from future sales of the Fund's gold.

However, before initiating any approach to membership, the staff representative noted, the Fund would expect that the decision of dissolution of Czechoslovakia would have already been taken in the country, and that raised the question of the constitutional method to adopt that decision. It was still unclear, for instance, whether that method would involve the federal Parliament or the parliaments of the two republics.

The Chairman said that he wondered whether it would be necessary for the method of dissolution to be agreed by all three parliaments, namely, at the federal and republican levels.

The staff representative from the Legal Department replied that the original intention of the authorities had been that the decision would be taken by the federal Parliament exclusively. The federal Parliament had considered a proposed amendment to the constitution that would have specified various ways in which the dissolution could be decided, one of which involved a further decision by the federal Parliament, while another involved an agreement between the parliaments of the two republics. The proposed amendment had not been passed by the federal Parliament, although it had subsequently decided to consider the issue again. It was possible that the federal Parliament would adopt a law to effect the dissolution of the federation directly, effective January 1, 1993, rather than first adopt a constitutional amendment on the procedure for taking such a decision. Those laws required a rather high voting majority; if the necessary majority was not obtained, the question would arise whether the parliaments of the individual republics could, in the absence of an amendment to the constitution, agree on the dissolution of the federation as of January 1.

In its preparatory work on membership for the successor states, the staff representative continued, the staff would be guided by the advice of the authorities of Czechoslovakia on the constitutional validity of the specific approach that was ultimately taken, but it would, as in all cases of membership, seek assurances in that respect from the relevant authorities before the membership issue could be resolved. In the meantime, the staff would continue its close contacts with the authorities on those technical, but important, issues. On the timing of the Board discussion on membership for the successor states, the intention was for the Board to meet before January 1, 1993 to consider the offer of succession to membership. That discussion would clarify for the successor states the conditions that they would have to meet to succeed to Czechoslovakia's membership as of January 1 to avoid any gap in membership.

Mr. Dorrington said that he wondered whether the data that had recently been received from the authorities were sufficiently accurate and comprehensive to enable the staff to make the quota calculations.

The staff representative from the European I Department responded that the staff had not yet looked at the data carefully, but they did appear to reflect a reasonable division of GDP between the two republics. The data on interrepublican trade were sketchy, however, and it would have to be seen whether those gaps could be filled and whether, in fact, all of the other data, some of which were based on earlier systems of accounting, were sound. Nevertheless, there was agreement between both republics on most of the data, which provided a good basis for beginning to assess the kinds of ratios that the Board might wish to consider in dividing the existing quota of Czechoslovakia among the successor states.

Mr. Esdar remarked that all of the points that he had wished to make had been covered by previous speakers. Therefore, he could limit his comments to supporting those speakers who had emphasized the need to maintain the momentum of the very successful reform process after the division of the country. He shared the view that close cooperation between both countries would be required not only to facilitate a smooth transition but also to improve further the economic prospects of both countries. He also wished to commend the staff for the very well-written and remarkably concise paper, which left little room for disagreement with respect to its economic analysis or its policy recommendations. He supported the proposed decision.

Mr. Fridriksson made the following statement:

As pointed out by Mr. de Groote, Czechoslovakia's policies have succeeded because the prerequisites for success were present, and firm policies were implemented with great determination after the political change. Developments in Czechoslovakia to date are impressive: inflation has been reduced sharply, production is turning around, unemployment has declined, and the external accounts are in a comfortable state. Moreover, considerable progress has been achieved in the structural area.

The lead speakers have comprehensively dealt with developments in Czechoslovakia. I will, therefore, limit my remarks to a few points.

I note that the weakening of the fiscal situation is partly attributed to the rapid changes in the structure of production--with a shift of resources into private activity and services--and an increase in tax avoidance, evasion, and arrears. This is a problem that has also surfaced in other economies in transition, and it may emerge in those that are in the early stages of transition to market economies. Can the staff comment on how the authorities plan to deal with it?

The process of privatization in Czechoslovakia has been extremely interesting, but I note also that no major bankruptcies have occurred. Could the staff elaborate further on why this is the case?

On the external side, it is particularly disappointing that trade barriers have been erected against Czechoslovakia's exports. Preaching the virtues of free trade to the economies in transition becomes all the more difficult the less it is practiced by the preachers.

The major uncertainty in Czechoslovakia today lies in the imminent partition of the country. The full implications of this are difficult to grasp now. The two parts are highly interdependent, but the state of development and the current economic situation appear to be quite different and could pose problems for the relations between them. It will be important to maintain the momentum of adjustment and reform in both republics.

We have watched developments in Czechoslovakia so far with admiration. They are of direct relevance for many countries that are in the early stages of transition. They would be wise to learn from the experiences of Czechoslovakia.

I agree with the staff appraisal and support the proposed decision.

Mr. Mwananshiku said that the authorities of Czechoslovakia had set a good example for other former Eastern bloc countries in their handling of the transition process, the adoption of appropriate policies, and in avoiding the economic deterioration that had occurred in some Eastern European countries. Implementation of the program had exceeded expectations. Inflation had been contained below 5 percent, real GDP had been better than expected, the employment record was impressive, the budget deficit was projected to decline, international reserves had increased, and a significant current account surplus had been recorded. Progress in structural reform was also impressive, especially the privatization of public enterprises. The "new wave" of privatizations would further strengthen the private sector. The reforms that were envisaged, including the establishment of a stock exchange, provisioning for bad debts, strengthening of banking supervision, and introduction of a bankruptcy law, would have a positive impact on the operation of monetary policy.

There remained areas for further consolidation, Mr. Mwananshiku considered. The budget remained weak, requiring an improvement in budgeting methodology, and the statistical base continued to pose problems for the design and implementation of economic policy. The staff representative had referred to possible budgetary, balance of payments, and unemployment difficulties in Czechoslovakia, which would require policy responses following the dissolution of the federation. The scope for further policy change was, however, dependent on the outcome of the dissolution process, which was fraught with economic and political uncertainties. Following the dissolution, policy coordination in respect of currency arrangement would be crucial. In that regard, he welcomed the fact that the dissolution process had been smooth and peaceful and that the authorities had avoided the catastrophes that had occurred in other countries in similar circumstances. Finally, the authorities should be commended for their decision to discontinue the use of Fund resources, given the strength of the external position.

Mr. Al-Tuwaijri made the following statement:

It is encouraging to note that, despite the impending division of Czechoslovakia, performance under the program exceeded expectations. Indeed, economic performance, in terms of real growth, employment, inflation, and the balance of payments, is better than expected, and the transformation process remains on track. In addition, the authorities commendably decided not to draw the remaining purchases under the stand-by arrangement, yet maintained the program's objectives and targets.

It is obvious that, after dissolution, the authorities of the two new countries will be confronted by significant challenges.

However, the current authorities' track record augurs well for future developments. In this regard, efforts to maintain a stable macroeconomic environment and to preserve confidence during the transition period will be imperative. Clearly, attempts of the current authorities to contain the fiscal deficit through a combination of expenditure-reducing and revenue-raising measures are commendable. Moreover, the recent agreement between the Czech and Slovak republics to introduce identical wide-ranging tax reforms is very encouraging. It is hoped that both authorities will attempt resolutely to redress the recent increase in tax avoidance, evasion, and arrears.

However, I am somewhat less sanguine about the prospects for monetary stability in both republics. As the staff paper suggests, monetary conditions have been markedly influenced by the substantial injection of liquidity through the balance of payments, by market-segmentation effects of impending partition, and by an increasing trend of currency substitution. The authorities' reduction of their net domestic assets targets and the increase in interbank rates are welcome developments. Nevertheless, it will be necessary for the authorities of the prospective independent republics to emulate their recent agreement on tax reform with regard to the institutional framework for monetary, trade, and exchange arrangements. As noted by the staff at the outset of the meeting, existing regional differences could render these efforts even more difficult.

In conclusion, I commend the current authorities of Czechoslovakia for their efforts to ensure a smooth economic transition, and I wish the authorities of both the republics success in their future endeavors.

Mr. Shaalan made the following statement:

I can concur with the staff appraisal, and I wish to raise only one question regarding the quantitative restrictions that have been imposed on some of Czechoslovakia's steel exports by the EC. Specifically, I would appreciate some elaboration by the staff on the rationale underlying the imposition of these restrictions, and on the staff's assessment of the prospects for their elimination in 1993. In this context, I wish to stress that market access for countries undergoing transformation, as well as developing countries in general, is a matter to which utmost importance should be attached; such restrictions stand in contradiction to the stated objective of EC members of assisting economies in the transformation process.

I wish to join other Directors who have commended the authorities on both the economic performance under the stand-by arrangement and the smooth manner with which they are handling the dissolution of the federation, and I hope that this spirit of cooperation will continue in order to reduce the risk of economic disruptions.

Finally, I wish to commend the staff on the refreshing brevity and clarity of the staff paper. I support the proposed decision.

Mr. Evans said that it was worth recalling that the primary purpose of the current review under the stand-by arrangement was to review fiscal policy midway through the program, which helped to explain the silence of the staff paper on the many other issues that were clearly of interest to the Board and, of course, the Czech and Slovak authorities. The paper noted that there had been some slippage in fiscal policy, as the revised estimate for the fiscal deficit in 1992 had been raised to 4-4.5 percent of GDP, which had to be compared with the statement of the authorities in their letter of intent of April 1992 that they "are committed to limiting any budget imbalance to substantially less than 2 percent of GDP" (see EBS/92/42, 3/9/92). In the same letter, the authorities had also said that "contingency measures have been discussed and will be implemented in the event that the fiscal position weakens to a point where they are warranted." Clearly, those commitments had not been met, which would cast doubt on the outcome of the review if it were restricted only to the primary purpose of the review, which, as he and the April staff paper had indicated, was fiscal policy, because the concerns that the staff had expressed at that time about fiscal policy had been borne out.

In looking at the performance of the economy more generally, however, and in particular the way in which the authorities had financed the overrun in the fiscal balance, there were no real grounds for not completing the review, Mr. Evans considered. The point was, however, as Mrs. Hansen had said, that the fiscal performance in 1993, which had been difficult to quantify at the start of the program, was likely to be even worse than originally expected. Moreover, as Mr. Posthumus had emphasized, fiscal policy would assume much greater importance following the dissolution of the country into two republics, and it would be very difficult to operate currency arrangements in that situation. Indeed, the three-phased arrangement to which Mr. de Groote had referred in his statement seemed like a rather dangerous route to follow. Certainly, Phase Two, which envisaged two separate currencies related initially by a fixed exchange rate, was likely to be extraordinarily short unless something could be done about the fiscal problems. He would be interested to learn whether the staff had any information on the potential for fiscal transfers under the new arrangement. In particular, he wondered whether there was an agreement on the provision of transfers from the Czech republic to the Slovak republic, because it appeared that the Slovak republic would have both greater need for expenditures and a lower tax base than the federation at present.

Mr. Kaeser remarked that the success achieved thus far by Czechoslovakia in its economic transition was encouraging and of great comfort to his chair and all of the countries that were struggling toward a free market economy. In light of the informal discussion on the status of Yugoslavia on November 13, 1992, he was also impressed by the civilized manner in which the division of the country had been handled. Like previous speakers, he very much hoped that the numerous agreements regulating the future economic relations between the successor republics would be swiftly ratified by both republican parliaments. He also hoped that Slovakia would not endanger the progress made so far on the way toward economic transition by indulging in a marked slowdown in the pace of reform. Slovakia would probably need more intensive care than its sister republic after the dissolution of the federation. He supported the proposed decision.

Mr. Kagalovsky made the following statement:

> We share the view that the achievements of the economic stabilization program in Czechoslovakia are very impressive, even if the absence of major macroeconomic imbalances at the outset of the program is taken into account. Rigorous implementation of sound fiscal and monetary policies has resulted in remarkable improvements in key macroeconomic indicators. Revised projections for 1992 indicate that the success of the program has exceeded all expectations: consumer price inflation for 1992 as a whole is projected to be 9.1 percent, instead of 12 percent; registered unemployment, 5.3 percent instead of 9.5 percent; the current account, $700 million in surplus instead of $600 million in deficit; and net international reserves, $3.4 billion instead of $2 billion. On the basis of the strong balance of payments position, the authorities have been able to make a prudent decision to refrain from taking up the remaining purchases under the current arrangement with the Fund. The rational credit policy of the authorities is also evident.
>
> Achievements in structural reforms and systemic changes are no less impressive, especially in the area of privatization. It is expected that, before the year's end, the process of small-scale privatization will be fully completed. The program of voucher privatization of large state enterprises seems to be making rapid progress. We, in Russia, are following and studying this unique undertaking with the greatest interest and sympathy. However, the finances of the enterprise sector have to be further streamlined and the bankruptcy regulations have to be put into effect.
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> We hope very much that, despite the forthcoming dissolution of the Czechoslovak federation, these remarkable achievements can be sustained and further consolidated next year. We also hope that coordination of monetary and exchange rate policies during the common currency period will prove to be workable and much more

successful than it has been in some neighboring countries. I would also remind Directors about the very disappointing experience of some other dissolving countries as regards the division of external debts and assets. I hope that Czechoslovakia will go ahead with the tradition of "velvet" transformations, from Velvet Revolution to "velvet divorce."

Apart from the strains associated with the splitting of the country, the independent Czech and Slovak republics will face numerous other challenges. The most recent developments in the fiscal situation are quite disturbing. On top of that, as a result of the upcoming tax reform, there is the possibility that there will be substantial losses in tax revenues in the first several months of 1993. With the introduction of the VAT and the abolition of direct wage control, the authorities will have to cope with additional inflationary pressures. All of these circumstances have to be fully taken into account and properly budgeted.

In conclusion, I would like to express our full support for the proposed decision.

Mr. Jamnik made the following statement:

We commend the authorities for the impressive results achieved under their 1992 Fund-supported stabilization program. Particularly noteworthy is the better than expected outcome with respect to prices, output, and the balance of payments. The low inflation rates recorded since the beginning of 1992--about 0.5 percent a month--and signs of an upturn in economic activity in the first half of the year are very encouraging. The performance of the external accounts has also exceeded expectations, in part reflecting strong export growth to Western markets combined with foreign direct investment inflows. This has allowed a substantial buildup of foreign reserves, as a result of which the authorities have decided not to draw the remaining two tranches under the current stand-by arrangement. Significant progress has also been made with respect to structural reforms, particularly in the area of the privatization of large state enterprises.

However, the fiscal position weakened markedly in the third quarter of 1992, owing mainly to an erosion of revenues and some underbudgeting for earlier commitments, jeopardizing the prospects for meeting the program's fiscal objective. To their credit, the authorities moved quickly in the face of a complicated political situation to take action in order to limit the extent of the overrun. Even so, the budget deficit for 1992 is expected to reach 4-4.5 percent of GDP compared with 3 percent of GDP under the program. Given the favorable price and external performance to date, we concur with the staff that this overrun may be accommodated without serious implications for macroeconomic stability, as long as strict expenditure control is maintained in the remainder of the year.

Looking ahead, the authorities are likely to face some formidable challenges in the fiscal area, mainly as a result of the impending dissolution of the federation. Indeed, as pointed out by the staff in EBS/92/162, a breakdown of fiscal policy coordination between the federal and republican governments may have already been responsible for the recent deterioration of the public finances. This problem will likely be exacerbated following the separation of the republics, unless appropriate fiscal arrangements are worked out and the authorities of the two new independent states take decisive action to rein in imbalances.

Another serious cloud on the horizon relates to potential revenue losses associated with the implementation of the planned tax reform in 1993. While most of the required legislation for the reform has been put in place, there have been important delays in the implementation of measures to improve tax administration and collection. We would, therefore, urge the authorities to take immediate action in this area in order to minimize likely revenue losses.

Relatively restrictive monetary and credit policies, particularly in the face of a substantial injection of liquidity through the balance of payments, may be credited for the impressive inflation results achieved so far. In light of the planned introduction of the VAT in 1993, potential wage pressures in the wake of the ending of tax-based incomes policy, and an uncertain fiscal outlook, it is of paramount importance that the authorities remain vigilant and continue to use a firm hand in the conduct of monetary policy.

We are pleased to see that, despite the impending dissolution of the federation, the authorities have continued to make important progress on structural reforms. In particular, we note that the first wave of voucher privatization has been almost completed and that conventional privatization is continuing apace. Some progress has also been made in developing the institutional and regulatory framework for the securities markets. The regulation on IPFs has been reinforced, and a securities law is expected to be submitted to Parliament shortly. However, there have been delays in the implementation of the bankruptcy law, as the authorities have decided to postpone the enforcement of a clause due to come into effect in October 1992 that would have also permitted bankruptcies of firms on the grounds of illiquidity alone.

While we agree with the staff that there may be reasons to amend the bankruptcy law to allow protection of enterprises against unnecessary bankruptcy, this must not prevent the authorities from initiating bankruptcy proceedings against insolvent enterprises in the meantime. In a market economy, the inability of an illiquid company to borrow means that it is insolvent, or at least that it has been unable to convince markets of its solvency. While market failures can arise, they are rare. In the case of countries in transition, markets are not yet well developed and the confidence band around corporate financial positions is much wider. In such circumstances, the chance that an illiquid but solvent firm is closed is higher. Nevertheless, we are concerned that the clause aimed at protecting illiquid but solvent firms may be misused, leading to support being given to insolvent firms. If sizable government losses are to be avoided, it is crucial that in such cases the Government examine closely the financial position and prospects of the companies in question. Open-ended commitments must also be avoided.

Depressed imports but also strong export growth, combined with substantial direct foreign investment, have led to a better than expected balance of payments position this year. However, the outlook for sustained favorable performance in this area is somewhat uncertain. We note that the recent growth in exports is largely attributed to greater access by Czechoslovakia to EC markets. In light of this, we view with regret the recent quantitative restrictions imposed by the EC on imports of certain steel products from Czechoslovakia, which, if renewed next year, will likely have a significant and ongoing adverse impact on exports. The impending dissolution of the federation may also have a dampening effect on foreign direct investment inflows.

The extent to which the economic performance of Czechoslovakia will be adversely affected by the dissolution of the federation will depend importantly on the ability of the authorities to effect a relatively smooth transition to a new political environment and preserve economic relations between the two independent states. We would encourage the authorities to do their utmost to fashion appropriate and workable monetary, trade, and exchange arrangements between the two new states, so as to minimize the economic disruptions and potential speculative flows from the planned political dissolution.

Ms. Duan made the following statement:

We commend the authorities for the very impressive results achieved so far under the stand-by arrangement. Even with the dissolution of the federation drawing close, bringing about complications and uncertainties, they have steadily pursued policies designed under the program and, at the same time, proceeded with systemic reforms. It is, indeed, encouraging that performance in real output growth, employment, inflation, and the balance of payments has exceeded expectations.

Under the current circumstances, these achievements are particularly valuable in reinforcing the confidence that is crucial for a smooth transition of macroeconomic management following the planned division of the country. We appreciate the authorities' decision to continue the stand-by arrangement, even if further purchases are not intended, so that close monitoring of economic policies can be maintained.

One area that needs monitoring and strengthening is fiscal policy. Although the budget was brought close to balance for the first half of 1992, revenue shortfalls and the failure to budget commitments already made have weakened the underlying fiscal position. However, it is encouraging to note that the authorities have taken all possible measures to offset the revenue impact of changes in the tax base and reinforced expenditure control while cutting subsidies and other current spending. Meanwhile, efforts should be directed to enhancing tax administration, as well as to implementing the planned tax reform, so as to further alleviate pressures on the budget.

The conduct of monetary policy has been complicated by capital inflows through the balance of payments, to which the authorities have reacted by tightening refinancing and lowering the target for net domestic assets. However, further challenges are imminent with the introduction of the VAT, the likelihood of a shift away from the tax-based incomes policies, and the emerging budgetary imbalances. The authorities will have to be ready, on the one hand, to rein in any inflationary pressures, while containing the risk of repressing economic activities that are just picking up, on the other hand.

Apart from the conduct of sound financial policies, we would also like to stress the importance of building an appropriate institutional framework for monetary, trade, and exchange arrangements, as well as proceeding further with structural reforms. Mr. de Groote's opening statement and the staff's comments provide very helpful information in this respect. We believe that these issues are of paramount importance for the economic transition process to be continued with minimum disruptions following the dissolution of the federation.

With these remarks, we endorse the proposed decision.

The staff representative from the European I Department observed that tax evasion, avoidance, and arrears were almost inevitable in a transforming economy, given the high degree of obsolescence in the tax system of a rapidly changing economy. The authorities' approach to that problem was to implement a wide-ranging tax reform, including the introduction of a VAT and a new income tax system, beginning on January 1, 1993. The reform would not be costless, however, in the sense that the VAT would raise prices and make it more difficult to control inflation; also, with a new tax system, there would be some initial revenue losses.

In recent weeks, the privatization process had continued to go very well, the staff representative said. The authorities had finished the fourth of five envisaged rounds under the first wave of privatization through the voucher scheme. Thus far, 80 percent of the shares had been allocated, and the authorities were confident that the first wave of the privatization process would be finished by the end of the year.

Although there had been a number of liquidations of enterprises, there had not yet been any bankruptcies of large enterprises, the staff representative stated. There was some rationale for postponing the implementation of the new, very rigorous bankruptcy law, particularly in the current circumstances, as there was a real concern that companies should be allowed to reorganize themselves while being protected from their creditors for a certain period. The bankruptcy law that would eventually be put in place would incorporate stronger protection in that regard. With respect to the distinction between insolvent and illiquid enterprises, a surprising number of enterprises that might well have been slated for bankruptcy proceedings had not been able to repay term loans but had been able to service their loans to the banks at penalty rates of interest of about 30 percent, about double the market rate. With that in mind, it might not be in the interest of the creditor banks, which were amortizing their loans to large enterprises through very high interest charges, to embark upon bankruptcy proceedings. The Government had also made it clear that it viewed closer scrutiny of the solvency of commercial enterprises as a task for creditors and not an appropriate task for the state.

On the nature of the current review under the stand-by arrangement, he would not characterize the purpose of the review as narrowly as Mr. Evans had, the staff representative said. In the March staff paper on the authorities' request for the stand-by arrangement, the staff had said that the review would pay particular attention to fiscal policy and progress under the program of systemic reform. Moreover, the authorities' commitment in the letter of intent to take additional measures if the deficit rose above 2 percent of GDP employed a definition of the deficit different from that of the staff; a 2 percent fiscal deficit in relation to GDP under the authorities' definition was equivalent to a 3 percent deficit under the program definition. While there were some concerns about the emerging fiscal deficit, the staff had been encouraged rather than discouraged by recent developments. Indeed, the authorities' resolve in embarking on a substantial package of measures, with the agreement of all political parties, in the context of the difficult national debate on dissolution was remarkable.

There would be no explicit fiscal transfers after January 1, 1993 from the Czech republic to the Slovak republic, the staff representative from the European I Department remarked. There would, however, be a variety of offsetting arrangements that might involve some reorganization of the sharing of certain revenues, particularly transit fees for natural gas from the former Soviet Union, which was piped through Slovakia and the Czech republic to Germany. The pricing of oil that was transported through the pipeline in Slovakia to the Czech republic was also open for discussion.

The Deputy Director of the Policy Development and Review Department said that the quotas on imports into Germany, France, and Italy of certain steel products originating in Czechoslovakia had been imposed by the EC for one year through the end of 1992. In explaining that measure, the EC had noted that the quotas would allow for an increase of 20 percent over the amount of steel imported from Czechoslovakia in 1991. On the rationale for the imposition of quotas, no reference had been made in the relevant EC decision to dumping, although it had been noted that certain steel products from Czechoslovakia were priced 20 percent to 30 percent below EC internal prices. According to the Official Journal of the EC, the EC Commission had concluded that it was necessary to adopt protective measures immediately in order to counter the injury that the imports from Czechoslovakia threatened to cause.

On the issue of fiscal targets, the Deputy Director continued, it had been noted in other discussions on Eastern European countries that the authorities and the staff faced very difficult problems in program design for the transforming economies because of the extreme degree of uncertainty. Consequently, in judging the adequacy of policy, a great deal of emphasis was placed on the overall results of a program. In the case of Czechoslovakia, both the balance of payments and inflation performances had exceeded the program objectives, which was obviously a key consideration that had to be taken into account. Also, the fiscal problem that Czechoslovakia faced arose from revenue shortfalls, which were closely associated with the change in the structure of the economy. Obviously, those very difficult problems would take time to solve, but the authorities were clearly committed to keeping expenditure under control and had already achieved a degree of success in that respect. He agreed with the point that Mr. Posthumus had made that, looking ahead, the staff should be increasingly careful in analyzing the implications of Slovakia's fiscal policy for the fixed exchange rate policy that it would follow after the dissolution of the federation.

Mr. de Groote made the following concluding remarks:

> I am certain that I express the feelings of all of my colleagues by saying at the outset that it is not without emotion that we conclude our last consultation with Czechoslovakia as a

country, no doubt the most successful of our member countries in making the transition to a market system. Despite the presence of separatist tendencies from the time of the Velvet Revolution onwards, the federation succeeded in pursuing strong and innovative policies. These have their reward today in the recovery of output, stable prices, strong penetration of exports in Western markets, substantial increases in reserves, and an effective transition to market mechanisms and to the privatization of the productive sectors.

Underlying all of the comments made by my colleagues, two major questions can be discerned. One of them concerns the past: how can we explain Czechoslovakia's successes, while all other transition countries have shown, to different degrees, mixed results? The other question concerns the future: can this performance be maintained by Czechoslovakia's two successor countries?

On the first question, the point is that Czechoslovakia, at the time of the Velvet Revolution, was not hampered by any major macroeconomic imbalances and had hardly any foreign debt, while its enterprises were already accustomed to a high degree of management autonomy. Between the Velvet Revolution and the initiation of its program at the beginning of 1991, Czechoslovakia was the only one of the transition countries to tighten instead of relax the restrictive stance of its monetary policies. Meanwhile, all of the major components of a market economy were being readied. Czechoslovakia was thus able, at the beginning of 1991, to liberalize at one stroke its prices, production, foreign trade, and payments system.

On the second question, the media generally assume that the partition is bound to have negative consequences for Slovakia but might turn out to be favorable for the Czech republic by relieving it of the transfer payments it presently makes to the other part of the federation. I recommend that we use extreme caution not to be swayed by such hasty judgments. We must not discount the danger to the Czech republic of any euphoria based on the cessation of its obligation to participate directly in the much higher transformation costs of the Slovak part of the former federation. We must, therefore, not reserve our recommendations for prudent fiscal and monetary policies to the Slovak republic alone; the Czech lands will also have to follow a very cautious path to avoid being victimized by media illusions.

In Slovakia, the hard decisions will be strengthened by the knowledge that they are being freely taken, instead of weakened by the perception that they are being imposed by Prague; and this, together with satisfaction at having recovered the national identity, will, in my view, increase the public's sense of responsibility and strengthen the courage to behave rationally. Recent statements by the Slovak Minster of Finance, Mr. Toth, are particularly reassuring on this point. He has pointed to the need for the Slovak republic to curb public expenditures more forcefully than was done when it was only a part of the country under the federation. Therefore, I do not think it unrealistic to assume that announced policies will be carried through without change. All of my own contacts with the Slovak Government since the middle of last summer, not to mention the contacts I organized for them with the staff, have clearly indicated the seriousness of purpose of the leadership of the Slovak republic.

Cooperation between the two successor republics will be strengthened by a common trade zone, a common tax system to be introduced on January 1, 1993, and an agreement on monetary management. Besides the points mentioned in my introductory statement, I would like to inform the Board of the agreement for achieving convergence on monetary matters during the period when each of the two successor countries will have its own currency related by a fixed exchange rate. During this interval, each of the two republics will have a 24-hour waiting period before adopting corrective action if: (i) 5 percent of total deposits is withdrawn from the banking system, (ii) the public sector deficit reaches 10 percent of total expenditure, (iii) reserves fall below one month of imports, (iv) or a basic disagreement arises in the Monetary Committee. If no agreement can be reached within the prescribed 24-hour period, the underlying premises of the monetary agreement will be revised.

As to the possibility that any of the parliaments, whether the federal Parliament or either of the two regional parliaments, might fail to ratify the partition agreement, allow me to stress that no such possibility exists, given the political composition of the parliaments and the agreement reached between the majority parties in each successor country. The whole process of the separation has taken place, up to now, in a civilized and friendly climate, and all further steps will be taken in a fully constitutional manner.

I am particularly indebted to Mr. Tabata and Mr. Shaalan for having drawn the Board's attention to the restrictions imposed on Czechoslovakia's steel exports by the EC at the request of some of its members. It is a fact that the production costs of these exports are lower than the productions costs of comparable exports from some EC producers. There is, in other words, no element of dumping in Czechoslovakia's present export prices. The issue is, therefore, perfectly straightforward: do we or do we not find it acceptable for countries to take advantage of favorable comparative costs? Is it or is it not the role of the Fund to continue to defend the most basic rule of the game in international trade?

Let me just add that while the export commodities in question represent less than 1 percent of the EC market for these products, they are crucial for the survival of the exporting Czechoslovak enterprises, whose rehabilitation is today being so warmly supported and applauded by my colleagues from the EC in this Board.

In ending, allow me to express, on behalf of my Czechoslovak authorities and on behalf of the authorities of the two future states, their gratitude for the Fund's involvement in their country's reconstruction and in the preparations for its partition. There is certainly one country of which it can never be said that its program was imposed by the Fund. Except for the Turkish program negotiated at the beginning of the 1980s, which also arose out of a very vigorous and constructive dialogue with the Fund management and staff, I cannot remember any program that has been so energetically discussed. Our gratitude goes particularly to the various mission chiefs, who have been patient enough to make this dialogue possible and productive.

Mr. Tabata said that, from Mr. de Groote's explanation of the trade restrictions that had been imposed by the EC on Czechoslovakia, he understood that the wage and production costs of Czechoslovakia's steel producers were below those of the EC countries. He recalled that in the most recent discussion on the Board's work program (EBM/92/132 and EBM/92/133, 11/4/92), general agreement had been reached on the need for the Fund to strengthen its surveillance function, in particular over the policies of industrial countries. Some EC countries continued to provide huge industrial subsidies--for instance, in the coal and steel industries--while imposing restrictions on imports from the transforming economies of Eastern Europe. Such a policy was somewhat contradictory, and the Fund should strengthen its approach toward the surveillance over policies in that area. Therefore, he strongly supported those Directors who had expressed strong concern about those EC policies.

The Chairman said that he fully agreed with both Mr. Tabata and Mr. de Groote about the need for the Fund to continue its vigilance in its surveillance function and in its efforts to promote free trade. Indeed, in the near future the Board would take steps to reinforce the Fund's surveillance over the policies of industrial countries. Recently, he had discussed the general issue that Mr. Tabata had raised with a French agricultural group in Brussels, and he would certainly continue those efforts, even if he could not promise early success. In that respect, it was very helpful that the Board was unanimous in agreeing on the need to maintain the Fund's efforts in that area.

Mr. Dorrington remarked that when he reported to his authorities on the discussion, he would certainly make sure that he included the point that Mr. Tabata and several other Directors had made, and he would hope that other EC Directors would do the same, although he feared that the relevant officials might be preoccupied with other trade-related issues at the moment.

The Executive Directors took the following decision:

1. The Czech and Slovak Federal Republic has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement approved on April 3, 1992 (EBS/92/42, Sup. 1, 4/16/92) and paragraph 23 of the letter of the Minister of Finance and the Governor of the State Bank dated March 2, 1992.

2. The letter of the Minister of Finance and the Governor of the State Bank dated October 12, 1992 shall be attached to the stand-by arrangement, and their letter dated March 2, 1992 shall be read as supplemented by the letter of October 12, 1992.

3. The review contemplated in paragraph 4(c) of the stand-by arrangement is completed.

Decision No. 10192-(92/137), adopted
November 16, 1992

2. ROMANIA - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on the review under the 10-month stand-by arrangement for Romania approved on May 29, 1992 (EBS/92/158, 10/6/92).

The staff representative from the Research Department, as head of mission, made the following statement:

Data recently provided by the authorities indicate that all end-September 1992 performance criteria were observed. Net credit to the consolidated general government declined by lei 17.3 billion in the first nine months of the year, compared with a programmed increase of lei 25.5 billion, as the fiscal position moved into surplus in the third quarter. Net domestic assets expanded by only lei 205 billion in the same period, remaining well below the program ceiling. In consequence, the growth of broad money was limited to 38 percent in the first nine months, approximately half the program target. Despite delays in disbursements from official sources, net international reserves increased by $156 million, in line with the program, owing to a significant improvement in the current account. The current account in the third quarter registered a surplus of $110 million against a projected deficit of $253 million, as export performance remained strong while imports declined sharply. Consumer prices rose by 10 percent in September, following the adjustments in administered prices and the effect of the exchange rate depreciation, but the increase was smaller than anticipated. In October, domestic fuel prices were also raised to international levels at the current exchange rate. Industrial output rebounded by about 7 percent in August-September, although it is still 30 percent below the level in the corresponding period of 1991. Unemployment continued to rise, reaching about 8 percent of the labor force in September.

In August, the stock of enterprise arrears declined slightly to lei 1.2 trillion on a gross basis--approximately lei 300 billion in net terms. In addition to the passage of the law on financial discipline, the authorities have recently intensified efforts to control and eliminate the arrears. An important measure taken on October 30 allows the Government to intervene directly and require enterprises with overdue payments to use domestic monetary assets to make these payments. In the event that this measure is not sufficient to bring arrears down, and the inflation objective of the program is threatened, the authorities have indicated their intention to lower the expansion of credit for the remainder of the year.

In the recent national elections, Mr. Ion Iliescu was re-elected President and the party supporting him--the Democratic National Salvation Front (DNSF)--obtained 28 percent of the seats in Parliament. The DNSF will form a minority Government, and Mr. N. Vacaroiu--an official in the Ministry of Economy and Finance--was designated as the Prime Minister. Both the President and the new Prime Minister are fully committed to the policies described in the letters of May 4, 1992 (see EBS/92/79, 5/5/92) and September 14, 1992 (see EBS/92/158, 10/6/92). The major opposition political parties have reached agreement on a common set of policies with the new Government to further the reform process.

Mr. Posthumus made the following statement:

My Romanian authorities are in full agreement with the staff appraisal contained in the staff paper on the review under the stand-by arrangement for Romania. The main message of this review is that the stabilization program has held up well and that the performance criteria have been observed. In the meantime, presidential and parliamentary elections have been held, and it appears that political support for the program has been maintained; an agreement on the major economic policy measures to extend and deepen the reform process has been reached between the winning party and the main opposition parties. The President and the new Prime Minister are committed to the current program. The fact that external financing has been provided slowly has made the adjustment more painful. In addition, the state-owned enterprise sector continues to have serious difficulties in moving in a more market-oriented direction. Yet, Romania has persisted in creating and strengthening the conditions for economic growth, such as liberalization of prices, reduction of inflation, and maintenance of convertibility of its currency, the leu. Significant achievements have also been made in transferring state property--particularly agricultural land and state housing--to the private sector, thereby laying the foundations for a market-oriented economy.

Romania is now almost at the end of the second year of Fund-supported programs, and the authorities remain committed to further close cooperation with the Fund in designing and implementing their reform program. There is still much to do. Financial stabilization has to be strengthened. Structural reform, in particular in the enterprise sector, is still an awesome task ahead. The risk that interenterprise credits--caused by state-owned enterprises supplying each other without direct payment--poses for monetary stability is still there, although to a lesser extent than last year. However, the authorities closely monitor the development of interenterprise credits. Recognizing that the state-owned enterprises, having become independent, are in fact not accountable to anyone, the authorities have issued a decree that enables the state, in its capacity as owner, to ensure that state-owned enterprises use available resources to make payments to creditors. This type of intervention is expected to control and limit the growth of overdue interenterprise credits.

The staff paper notes that the results of the program so far in 1992 have been mixed. Economic activity has continued to be weak. Industrial production in the first six months of 1992 was 20 percent lower than in 1991. In the statement of the staff representative, which was prepared one month after the staff paper on the basis of new data, some increase in production was registered in August-September, but it is still much below output in 1991. Agricultural output, too, has been falling, reflecting in part the expected short-run effects of the privatization of large collectives, but also the fact that the country has been experiencing a severe drought. While these data are, of course, disappointing, it should not be a surprise that the reform process has yielded limited results in a period of barely two years. In particular, turning around the enterprise sector, in terms of its entrepreneurial behavior, its organization, and even its marketing, is a Herculean task.

Foreign assistance, in addition to the Fund-financed stabilization programs, is vital in this adjustment period. Last year, bilateral support from the Group of Twenty-Four industrial countries (G-24) was nil, because commitments came late in the year. This year, disbursements from last year's commitments were substantial, but new commitments dropped. Romania continues to be in a very difficult financial position. The Government has made efforts to obtain some bridge financing against EC commitments, which will come forth after the present review. But continued foreign support for the country's reform and adjustment programs remains vital.

In my view, developments in Romania do not differ essentially from developments in most of the formerly centrally planned economies. Even with reform efforts that are rather strong, reform results come slowly. With many of its former markets lost, Romania and these other economies need access to the markets in Europe and beyond to stimulate exports and the economy, and consequently imports. The formerly centrally planned economies must be integrated into regional and global markets in order to be able to start growing out of their old and no longer functioning centrally planned system.

Extending his remarks, Mr. Posthumus said that earlier that day he had received information on the policy statements that the new Government had made to Parliament on November 13, 1992, which he could only summarize at present owing to the limited time for translation from the original Romanian language text.

The Romanian authorities would continue structural reforms, strengthening the democratic process and the transition to a market economy, while keeping the unavoidable social costs of transition under control, Mr. Posthumus stated. One of the major economic policy objectives of the program in 1993 would be to reduce and, if possible, stop the decline in production to allow for an increase in growth in the following years. A large and prompt adjustment of the industrial sector, which employed energy and other raw materials very intensively, would be undertaken in 1993. The state-owned and partly state-owned enterprises still represented, as in many other countries, a very large share of the industrial sector. Inasmuch as the privatization process had not yet been completed, the Government would try to introduce fixed-term management contracts for those enterprises, which would include performance criteria and the delineation of clear responsibilities for the managers of those enterprises. As he had mentioned in his opening statement, the authorities recognized that although state-owned enterprises had become independent in a sense, they were not yet accountable to anyone at present.

In agriculture, conditions would be created to exploit the very large agricultural potential of the country, Mr. Posthumus remarked. In that respect, an important measure would be to accelerate the distribution of land titles, as delays in that area had been a major obstacle to increasing agricultural production thus far. Further actions would be taken to modernize the financial system, improve fiscal policy, and enhance financial discipline. The value-added tax (VAT) would be introduced on January 1, 1993, and, in accordance with the program, the authorities would eliminate the remaining subsidies on consumer goods on May 1, 1993. The process of restructuring and development of the banking system would also continue.

The Government was looking into ways to improve the coordination of monetary, fiscal, and incomes policies between the Government and the central bank, Mr. Posthumus observed, although it remained unclear how it would be achieved; in a practical sense, that process had already begun, because the new Minister of Finance had been closely involved in the drafting and discussion of the letter of intent for the current review under the stand-by arrangement. The Government would also consider speeding up the privatization process and would try to encourage foreign investment. Finally, the Government would issue and submit to Parliament the basic principles of new laws for establishing a system of social assistance and pensions, which was long overdue.

Mrs. Hansen made the following statement:

> Although Romania continues to face a particularly difficult situation, it has so far continued to adhere to a rigorous economic reform program and to comply with the terms of its stand-by arrangement. We regret that the results have not been better in terms of output and inflation performance, but we are encouraged to see some bright spots in the economy, such as the rapid increase in private sector employment, the strong growth in exports to convertible currency markets, and the return of some capital flight. More recently, the surprisingly strong current account performance in the third quarter of 1992 and some signs of a deceleration in inflation and an increase in industrial production give grounds for some cautious optimism that there is light at the end of the tunnel.
>
> The major question at hand is how best to hasten the return to price stability and the resumption of economic growth. It is politically difficult to sustain restrictive policies after some three years of economic contraction, and, indeed, press reports at the end of last week suggested that resolve may be weakening. At the same time, the longer the economy is plagued by high inflation and currency depreciation, the harder it becomes to re-establish confidence.
>
> In our view, it is imperative to continue the strong financial policies that the Romanian authorities have been pursuing to date. A fiscal position as close to balance as possible and a restrictive monetary stance are required to stabilize the exchange rate so as to reduce price pressures and encourage foreign capital inflows.
>
> On the fiscal side, the authorities are to be commended for adopting additional measures needed to adhere to the original program target of a deficit of 2 percentage points of GDP. The

fact that the fiscal position has moved into surplus in the third quarter attests to the authorities' commitment. However, we agree with the staff that there is considerable scope to reduce subsidies, which at 7.5 percent of GDP represent a considerable drain on public finances. In fact, we were surprised to note in Table 5 of the paper that no progress is expected to be made in 1992 in reducing subsidies in relation to GDP, although consumer price subsidies have supposedly been reduced by 50 percent this year. Should one conclude from this that producer subsidies are on the rise? We also urge the authorities to implement the VAT as early in 1993 as possible with a view to achieving a timely move away from outmoded forms of taxation.

With regard to monetary policy, we note that credit demand has been very weak, even if one counts interenterprise arrears as normal credit expansion. We welcome the steps that the authorities have taken to eliminate interenterprise arrears, which, if not addressed, could have seriously undermined the effectiveness of monetary policy, not to mention operations in the industrial sector itself.

Regarding the degree of monetary tightness, we note that interest rate policy differs somewhat from some other programs in Eastern Europe, where, in some cases, a decision was made to set interest rates at a positive rate in relation to expected inflation for the year, rather than in relation to what inflation had been in the recent past, as in Romania. The balance of factors for and against a more forward-looking policy undoubtedly weigh on the side of caution in Romania, where the rate of inflation has been particularly high, currency depreciation has been quite rapid, and the need to avoid a further spiral of depreciation and inflation is particularly pronounced. Yet, the statement by the staff representative indicates that the monetary program has turned out to be much tighter than designed. Does the staff believe there is any reason for concern about excessive monetary tightness, especially in view of the profound weakness of economic activity?

In this connection, it would also be helpful to learn how the staff interprets the report in the November 13 edition of the Fund's Morning Press to the effect that the new Government is signaling its intention to slow the pace of reform. This report, if true, seems to be at odds with the thrust of the statements of both the staff representative and Mr. Posthumus.

Turning to the structural reform, we welcome the privatization of agricultural land and of housing. However, we agree with the staff that progress on enterprise reform has been insufficient. In fact, we suspect that the slow pace of restructuring state enterprises--and the economic uncertainty this engenders--

accounts in large part for the continued declines in economic activity. Admittedly, there are some encouraging signs. The staff paper indicates that there has been considerable labor shedding in the state sector in the first half of 1992. The adoption of Law 76 to enforce greater financial discipline is also a welcome step, which we hope the authorities will vigorously enforce. However, we hope the authorities will act upon their intention stated in their letter of September 14, 1992 to the Managing Director to accelerate the pace of privatization, and we would be interested in any details the staff can provide about the authorities' plans. At the same time, we urge the authorities to get on with the closely related issue of financial sector reform, and we hope in this connection that the World Bank's Financial and Enterprise Sector Adjustment Loan, which is now reportedly at an early stage of preparation, can be brought forward as soon as possible.

Finally, with regard to the external sector, we commend the authorities' steps to liberalize trade and improve the functioning of the foreign exchange auction. To the authorities' credit, these steps were taken notwithstanding considerable uncertainty about Romania's external situation. Yet, with rigorous financial policies in place, these liberalizing steps are no doubt speeding the reallocation of resources in accordance with market signals, without any detriment to the external accounts.

With these remarks, we commend Romania's continued adherence to its stand-by arrangement in the face of great difficulty, and we hope to see tangible rewards for their persistence in the near future.

Mrs. Martel made the following statement:

Romania has made great progress toward macroeconomic stabilization and, to a lesser extent, structural reform. It is of great comfort to this chair that all performance criteria have been met through the end of September. Significant reforms have been introduced by the Government, among them, the recent elimination of a number of consumer subsidies and import licenses, as well as the institution of a new foreign exchange system.

We certainly share the overall assessment of the staff paper. I will thus limit myself to four brief remarks, three of them of a policy nature, the fourth relating to external financing.

My first remark is about exchange rate policy in relation to wage behavior. The Romanian economy has heavily benefited from the nominal depreciation of its currency. Due to some nominal wage inertia, this has been translated into an effective real exchange rate depreciation, a significant improvement in competitiveness, and an unexpected increase in export volumes. However, it is clear that inflationary pressures are still very strong--indeed, current inflation is above the target level--and continued wage moderation cannot be taken for granted. A too big slippage would undoubtedly endanger the movement toward an improvement in exports and the trade balance. It is all the more important that the mechanisms that have been put into place to contain the increase in wages be kept and, if possible, reinforced. In a free-floating exchange rate system, a country such as Romania cannot rely on any other anchor in its stabilization program than the control on the development of wages.

My second concern is about the decline in output and its origins. The output loss in Romania seems very much in line with what happened in other economies in transition and, as such, could be seen as the unavoidable consequence of the move toward a market economy. Nevertheless, in the case of Romania, some signs may point to what might be a too restrictive demand-management stance in the overall policy mix: first, growth in both domestic credit and broad money has been below the programmed targets and, second, the current account has registered a surplus during the third quarter of this year, which is, of course, remarkable and partly due to the growth in exports, but it might also point to some excessive import compression.

In this framework, the relevance of the fiscal deficit target of 2 percent of GDP might need to be reassessed in the future. It is true that this does not represent the whole burden that the public sector inflicts on Romanian savings, as the losses incurred by public enterprises should always be taken into account as well. Nevertheless, the question whether such a target should be adhered to strictly in the immediate future and, even more, should be included in a successor arrangement deserves to be asked. I would welcome some comments by the staff in this regard.

My third comment is about enterprise reform. While it is encouraging that private sector employment today amounts to 35 percent of the labor force, the behavior of the public sector is still a source of some concern. The reappearance of interenterprise arrears is worrisome; although it does not threaten, in the short run, macroeconomic stability--as it has been overcompensated by lower than programmed domestic credit--it is certainly a sign of very weak financial discipline. Arrears enable the public enterprises to delay adjustment to market conditions; they allow for the development of production that, in its level and composition, might be unrelated to effective demand. In such a situation, the price system cannot play its role in guiding the allocation of resources. Therefore, we certainly support the staff when it says that everything should be done to prevent the increase and development of those arrears. Privatization of the public sector will inevitably be spread over a long period. In the meantime, it is essential that those enterprises that remain in the public sector be constrained to behave under a normal financial discipline. The suggestion by the staff that the authorities could introduce tax incentives to induce the charging of market-based interest rates on interenterprise credits is very much welcome.

My final remark is about external financing. The overall financial resources available to fill the financing gap seem appropriate for 1992. Indeed, if the staff's forecasts are correct, there might be a stronger than expected increase in reserves. However, the origin and composition of those resources are a source of some concern. We find it especially regrettable that disbursement of funds under the World Bank's structural adjustment loan has proved much slower than necessary. Disbursement of the first tranche of that loan, which was due to be disbursed as soon as the loan became effective, has still not been completed. Disbursement of the second tranche before the end of the year seems to be unlikely. These delays are entirely related to Romania's difficulties in implementing procurement rules and practices for eligible imports under the normal procedures of the Bank. It seems to me that greater efforts in providing technical assistance and external expertise would have prevented these difficulties and would have placed Romania in a better and firmer external financial position.

This being said, let me reiterate our appreciation for the course on which the Romanian authorities have embarked and the success they have already registered.

Mr. Thorne made the following statement:

Let me start by joining Mrs. Hansen and Mrs. Martel in applauding the authorities' commitment to their stabilization targets, including making fiscal corrections where necessary, in the face of the severe contraction of output. Should further fiscal slippage occur, I would support the proposal to bring forward subsidy cuts, as this can address resource allocation distortions as well as the fiscal imbalance.

The doubling of the projected fall in output this year to 10 percent is disturbing. Perhaps even more disturbing are reports that industrial production for the year to date is as much as 30 percent below that of a year ago, and the cereal harvest is down by 45 percent. Could the staff comment on the risks that the fall in overall output will, in fact, be even greater than that projected in the paper and on the encouragement we might gain from the news that production may, as Mrs. Hansen said, be turning up slightly on a month-to-month basis?

Meanwhile, despite the much worse than expected level of activity, the increase in unemployment has not matched earlier fears. While this is, of course, good news, it carries the risk that the explanation of these divergent indicators is a weakening of productivity and high levels of unemployment. What is the staff's view on this issue?

I welcome the news reported in the statement by the staff representative that the new Government is fully committed to the policies originally agreed under the stand-by arrangement, as well as in Mr. Posthumus's remarks. Like Mrs. Hansen, I urge the authorities not to let the pace of structural reform slow. The restructuring and privatization of enterprises are crucial if the fragile evidence of the past few months of a bottoming out in output is to be sustained. The clarification of asset values of enterprises, prompt issuance of ownership titles for land, and encouragement of agricultural efficiency and investment are all useful areas for action.

We very much share the staff's view that insufficient progress in enterprise reform is the principal weakness in Romania's economic transformation. Like Mrs. Martel, I note that liberalization of prices, trade, interest rates, and other macroeconomic areas can have only limited impact when proper relations between institutions, based on adherence to contracts, do not yet exist. This could not be better illustrated than by the reports of enterprises' willingness to go into arrears rather than pay market interest rates for funds. In this context, the recent intensified efforts to deal with interenterprise arrears are very welcome, as is the authorities' commitment not to undertake another global compensation operation. The staff paper says that the authorities believe that Law 76 will allow them to control and eliminate arrears, and it notes that future World Bank conditionality will limit gross arrears to 7.5 percent of turnover. I wonder whether the staff could indicate whether it shares the authorities' optimism about the new law and what the current ratio of arrears to turnover is for enterprises.

Still on interenterprise arrears, with net domestic assets well below the benchmark so far for 1992, I regard the alternative action--should arrears not, in fact, be reduced--of reducing the rate of credit expansion as very much a second-best approach. The main danger from continuing arrears seems less their effect on the monetary stance than the associated distortion of markets and the damaging effects on business confidence. Altering the rate of credit growth will not do much to address these latter problems.

It is true that slower progress than expected in reducing inflation argues for maintaining a firm monetary stance. However, as others have noted, credit growth has been far weaker than expected and thus provides a sharply conflicting signal. The sharp gyrations in velocity of money do not provide encouragement that monetary aggregates can be fine-tuned in order to achieve the inflation objectives. Instead, a steadily firm stance seems appropriate while structural measures are pursued.

As far as the inflation objective itself is concerned, I welcome the continued commitment to achieve 1-2 percent monthly inflation by the end of this year, despite the disappointing developments to date. However, I hope this objective is not to be interpreted too narrowly. The inflation rate has been very volatile from month to month, as it has been highly dependent on the precise timing of administered price changes and subsidy reductions. It will be unwise to become too encouraged or, indeed, alarmed by the figures for one or two months. Logically, it is perfectly correct to try to monitor real interest rates and wages measured against projected inflation. But one must be very cautious not to jump to conclusions and, indeed, to lower interest rates too abruptly through overenthusiastic extrapolations of the recent past. I have seen reports that the bank discount rate has now been lowered to 60 percent. I would be grateful for the staff's comments on the real rate of interest that this implies, and the reasoning behind the move. I would also like to learn more about the relationship between wage rises and subsidy reductions, and the effect that this has on both inflation expectations and the overall fiscal position.

The authorities have taken commendably quick action in unifying the exchange rate, and the extra confidence in the currency that seems to have resulted has perhaps helped to take pressure off interest rates. But I understand that the daily fixing of the exchange rate was suspended in late September 1992, perhaps because of the uncertainties surrounding the election. I would be grateful to know whether the daily fixing of the exchange rate has now been reinstated and whether the staff believes that the suspension has had an effect on market confidence.

The small current account surpluses in recent months are encouraging, as other speakers noted. But the continuing weak level of reserves, the continued import compression, and the highly uncertain prospects mean that the overall balance of payments remains fragile. Therefore, I join the staff in its call for timely international support. The EC has already agreed in principle to a loan of ECU 80 million to help fill the financing gap for 1992. I urge other countries to consider making matching contributions.

The staff representative from the Research Department, commenting on a report in the November 13 edition of the Morning Press, noted that the President of Romania, in his inaugural speech to Parliament, had stated that there would be no slowdown, let alone a reversal, of the reform process. The somewhat misleading interpretation that some observers had drawn from the President's speech to Parliament was, perhaps, based on the increased emphasis that the Government intended to place on intervention by the state, as owner, in state-owned enterprises through the establishment and enforcement of management contracts and other techniques to improve enterprise management. At present, enterprises had a completely free hand in running their own operations, and they were not accountable to anyone. Among the results of that virtual independence was the lack of restructuring and the buildup of interenterprise arrears. If reform was defined merely as a rapid disengagement of the state from economic activities, then there would be a slowdown of reform in Romania, but that was not the staff's interpretation. Indeed, until privatization was complete, it was entirely appropriate for the Government to exercise some control over the behavior of state-owned enterprises. It had been made quite clear, however, that the Government would not interfere in the day-to-day management of those enterprises.

On the more general issue of interenterprise arrears, the staff representative continued, those arrears had begun to increase again in 1992--following the explosive growth in arrears in 1991 and their subsequent elimination through a global compensation operation--owing in part to the problem of moral hazard. In fact, recognition of that problem had influenced the drafting of the new law on financial discipline, designated Law 76. Owing to delays in passage of that law, however, there had been a substantial buildup of arrears in the first half of 1992, which had subsequently leveled off following passage of the law in July 1992. With respect to World Bank conditionality on interenterprise arrears, the terms of the structural adjustment loan (SAL) required gross interenterprise arrears to be no more than 7.5 percent of enterprise turnover. Arrears currently amounted to about 20 percent of GDP, and as Romania's GDP was equivalent to approximately half of turnover, arrears were somewhat over the stated limit under the SAL.

As a result of the reluctance of enterprises to settle their overdue accounts through the courts, even under the provisions of Law 76, the Government had recently decided to intervene directly and enforce settlements, the staff representative said. Teams of auditors from the National Bank and the Ministry of Finance would examine the financial position of the enterprises responsible for the largest amount of interenterprise arrears, and were to be given the authority to require enterprises to use their monetary assets to clear such arrears. The Government had been fairly successful in securing the settlement of arrears in a number of recent cases, in particular in the energy sector, and the staff was reasonably confident that the various measures the Government was undertaking would be able to reduce the total stock of arrears.

The authorities' wage policy, which was based on a forward-looking indexation scheme, had remained essentially unchanged, the staff representative observed. The coefficient of indexation, which had been set at 0.5 in November 1991, had been maintained thus far. Wages had been adjusted, however, partially to compensate for the increase in administered prices, and the effective indexation coefficient was therefore somewhat higher than 0.5, although it was still significantly less than 1. Real wages were expected to decline on average by about 18 percent in 1992, after having declined by 14 percent in 1991. Although there was a great deal of pressure from trade unions to increase wages, especially immediately following the election, the Government remained firm in its policy of ensuring that wages rose by less than the projected rate of inflation.

The refinance rate of the National Bank of Romania had not been lowered to 60 percent, as one speaker had suggested, but was still 80 percent, the staff representative observed. The Board of Directors of the National Bank had given authority to the management to lower interest rates at management's discretion. As the monetary authorities were not yet convinced that inflation had been brought under control, however, they had not yet decided to lower interest rates. The extent to which real interest rates could be considered too high depended to a large extent on the deflator that was used to calculate real interest rates. The underlying rate of inflation was about 3 percent, which implied that real interest rates were positive in real terms; on the basis of an optimistic scenario of declining inflation over the coming months, real interest rates would be very highly positive. A more worrisome trend was the very large spread that had emerged between lending and deposit rates. During the previous program, there had been a feeling in the Board that the limit on interest rate spreads should be eliminated; accordingly, the staff encouraged the authorities to do so, and the restriction on the size of the spread was eliminated. Recently, however, the spread had become excessive, owing partly to the fact that interest rates offered by the Savings Bank, which were very difficult to change quickly, tended to be well below rates offered by commercial banks.

Although the process appeared to be slow, the authorities were proceeding as quickly as possible with privatization, given the constraints under which they were operating, the staff representative considered. Almost all of the privatization vouchers, representing 30 percent of the capital of state enterprises, had been distributed, and a number of commercial units had been sold. The major obstacle was in the enterprise sector, where privatization was moving very slowly, although progress had been very encouraging in the retail and commercial sectors. The privatization of the agricultural sector was almost complete; indeed, the decline in agricultural output in 1992 was, in addition to the drought, attributable to the breakup of collectives, which had resulted in a large number of small land holdings, for which the capital equipment and technology available in Romania was not well suited. Moreover, many land holders did not yet have full title to their land, although a major effort was being undertaken to establish property rights through the timely issuance of land titles. Almost all of the state housing stock of about 2 million units had been sold, at historical prices, to private agents; the sale of about 250,000 units was still in dispute owing to questions of restitution and prior ownership.

The system of fixing the exchange rate had not been abandoned at the end of September 1992, and the rate had remained fairly stable at about lei 430 per $1, the staff representative said. The Fund had provided substantial technical assistance to the authorities in the operation of the exchange auction, and its conclusion was that the system seemed to be working reasonably well given the constraints on the supply of foreign exchange. Previously, Romania had instituted a system of full surrender requirements on exporters, which had not worked well in encouraging enterprises to bring foreign exchange earnings back into the country. Under the current program, the authorities had implemented a full retention system. The first stage in the implementation of that system had been quite successful, as enterprises had begun to bring foreign exchange earnings back into the country and to hold them in the form of foreign exchange deposits in the banking system. However, enterprises were not yet ready to sell foreign exchange in the market owing to uncertainties about the ability of the National Bank to supply foreign exchange on demand. The international reserves of the National Bank were probably still somewhat below a critical--albeit unquantifiable--level, above which enterprises would be willing to sell in the market with the expectation that they would be able to buy foreign exchange when the need arose.

Under the current program, consumer subsidies were to be eliminated gradually in three stages, culminating in their complete elimination in 1993, the staff representative recalled. The first two stages had been completed as planned by September 1, 1992, and, according to the recent statement to Parliament by the Prime Minister, the timetable for the final stage was still in effect. Producer subsidies, which amount to about 2.5 percent of GDP in 1992, were allocated primarily between the mining companies and the railroad company. Some nonferrous mines had been closed down, and the authorities were considering the best approach to restructuring the remaining mining companies, which largely operated coal mines.

The fiscal performance through the third quarter of 1992 had been much better than programmed, and the deficit for the year as a whole was expected to be about 2 percent of GDP, the staff representative from the Research Department remarked. As Mrs. Martel had noted, however, if the estimated losses of state-owned enterprises were also taken into account, the resulting quasi-fiscal deficit for 1992 would be considerably larger, probably on the order of 5 or 6 percent of GDP.

Mr. Thorne recalled that the staff representative had mentioned that the interest rate policy of the Savings Bank might be partly responsible for the extremely high spread between deposit and lending rates in Romania. He wondered whether the high level of arrears was also a contributing factor. Some further elaboration on the risks that the output decline would turn out to be worse than 10 percent for 1992, and on the relationship between the output decline and unemployment, would also be welcome.

The staff representative from the Research Department agreed that interenterprise arrears certainly could help to explain the large interest rate spread in Romania. The importance of the Savings Bank's interest rate policy on the size of that spread should not be underestimated, however, as the Savings Bank effectively set the deposit rate for the rest of the economy. The combination of relatively low deposit rates of the Savings Bank and the 80 percent refinance rate had led to an interest rate spread of about 30-40 percent in nominal terms. The Savings Bank, which was a very large institution, was clearly in need of restructuring; in addition to the staff's advice, the authorities were receiving technical assistance from various external sources in that connection.

While there was, indeed, a risk that output could be worse than anticipated in 1992, the staff representative continued, the staff was encouraged by the modest turnaround in industrial activity in recent months, and the original target of minimizing the output decline to 10 percent was still realistic. Under the program, unemployment was expected to rise to about 1.5 million, or about 15 percent of the labor force, but was currently expected to reach only about 1.1 million. It was possible, of course, that the better than expected unemployment result reflected in part the reluctance of state enterprises to shed labor rapidly. However, there had been a very rapid increase in private sector employment, which was certainly an encouraging sign for the future.

Mr. Esdar made the following statement:

> The staff has provided an excellent and concise paper on the Romanian program, and I do not have much to add to the staff's analysis and recommendations.
>
> While the Romanian stabilization program is on track, as indicated by the observance of the end-September performance criteria, the impact on economic activity has been somewhat mixed. In particular, the high level of inflation remains a major problem. Therefore, I can fully go along with the staff's strong recommendation to keep the budget deficit under control and to pursue a tight monetary policy. Somewhat in contrast to the staff, however, I wonder whether the flexible exchange rate policy that has led to a continuing rapid depreciation of the leu has not contributed to inflation by creating a devaluation-price spiral, which is reinforced by an admittedly moderate degree of wage indexation. Perhaps the staff could address this question, especially against the background that some other Eastern European countries have been more successful in fighting inflation by anchoring their domestic policy in a stable exchange rate system. However, I am fully aware that such a policy course would require an appropriate level of reserves. Therefore, I would like to join Mr. Thorne in encouraging non-EC G-24 countries to increase their efforts and to provide the necessary financial support.

A second area of concern is certainly the re-emergence of interenterprise arrears. This point has been discussed in detail by other speakers. However, I would like to point out that delays in the implementation of necessary reform measures in this area would further fuel the moral hazard problem. It is, therefore, of crucial importance to send a strong signal to the enterprises concerned that further arrears will not be tolerated and that the new instruments will be applied decisively. Such a message would be especially important because the reform of the large state-owned enterprises does not seem to be proceeding with the originally envisaged speed, perhaps owing to bureaucratic obstacles or even resistance on the part of managers.

Freeing market forces, limiting government intervention, and overcoming bureaucratic bottlenecks are crucial for Romania's further success in its transition process. A convincing commitment to implement the necessary reforms will be critical to encourage international capital flows and foreign direct investment. This is especially important as official lending has to be replaced by private flows in the years to come, not least in order to prevent prolonged financial involvement of the Fund in Romania.

Finally, I welcome the fact that the new Government will remain committed to the reform process, and, like previous speakers, I applaud the authorities for the success achieved so far. I can support the proposed decision.

Mr. A. R. Ismael made the following statement:

Despite the continued decline in economic activity and the higher level of inflation now projected for 1993, it is encouraging to note that progress has been achieved in stabilizing and restructuring the Romanian economy and that important headway has been made as regards privatization. Thus, we note that monetary and fiscal performances are broadly in line with the program targets and that price liberalization as well as exchange and trade liberalization measures have been implemented. Moreover, we welcome the increase in private sector employment and the signs that flight capital is returning. These are significant achievements considering the difficult environment in which the reforms are being implemented, and we commend the Romanian authorities for their resolve in maintaining the pace of adjustment.

We are in general agreement with the thrust of the staff appraisal and with its policy recommendations. We would like only to make some brief comments on the fiscal sector, public enterprise reform, and external financing.

In the fiscal sector, we note that the deepening output loss has led to a shortfall in fiscal revenue, which the authorities have appropriately addressed by taking additional revenue measures and reducing subsidies to ensure that the fiscal target is met. However welcome these measures are, more efforts are needed in the fiscal area. As other speakers have noted, there is a need to improve the tax collection system as well as to increase control over expenditure. In this regard, we would encourage the Romanian authorities to consider accelerating their fiscal reform plans and also to consider further reductions in consumer and producer subsidies.

As regards public enterprise reform, we welcome the recent measures taken to accelerate the program of privatization. However, we note that a lack of financial discipline has again led to an accumulation of arrears. We share the staff's views that the arrears problem needs to be addressed as quickly as possible, and steps should be taken to prevent its re-occurrence. In this regard, the new law on financial discipline is welcome, and we encourage the authorities to be firm in its implementation. As stressed by the staff, "without appropriate enterprise reform the stabilization and structural reforms will be thwarted." In addition, it appears that the slow pace of reform in the public enterprise sector may be an important factor in the fall in real output. We, therefore, encourage the Romanian authorities to persevere steadfastly in their efforts. We would also urge the authorities to continue in their efforts to create the appropriate environment conducive to the development of a strong private sector by providing the necessary incentives to private entrepreneurs.

With respect to external financing, while a significant amount of commitments have been disbursed, it is likely, however, that there will be some shortfalls in official financing in 1992. This is, indeed, disappointing, given the strong commitment of the Romanian authorities to the adjustment process. Small capital inflows at a time when output is falling can only increase the burden of adjustment by restraining demand and further depressing the economy. In the circumstances, the danger of a slowing down of reforms and of the privatization process cannot be ruled out. We would, therefore, urge creditors and donors to be more forthcoming with financial assistance to Romania.

We support the proposed decision.

Mr. Dlamini made the following statement:

The Romanian authorities have made considerable progress, particularly toward price liberalization and removing restrictions on the exchange and trade system. They have shown praiseworthy commitment to adjustment and reform policies in the face of the difficult external environment. In many respects, Romania is today different from what it was in 1990, when the transition to a market economy was begun.

Despite the progress made in various areas, economic activity has continued to be weak, inflation, although moderating somewhat during the latter part of 1992, remains high, and unemployment is rising. The process of increasing output is likely to be difficult, as the authorities are at the same time determined to pursue a tight fiscal and monetary stance in order to reduce inflationary pressures. Without a significant reversal of the output trend, the unemployment situation may continue to worsen. The continued slump in production, the rise in prices, and the unemployment problem may breed discontent, which could be unhealthy for the transformation effort.

In these circumstances, prompt and appropriate measures are necessary to enhance the supply response of the economy, while containing inflationary pressures. The authorities' commitment to the continued pursuit of their liberalization and adjustment program, which is aimed at sustaining economic stabilization and adjustment in the context of balance of payments viability and low inflation, is welcome.

The success of Romania's economic transformation does not depend on the strength of the domestic adjustment effort alone. The country will continue to require substantial external support, including increased access to the markets of industrial countries. The negative effects of the collapse of former CMEA-area trade on Romania's domestic economic activity and the balance of payments have been significant. Until a new trading pattern is established, it will be difficult for Romania to reverse the current adverse developments in output, employment, and inflation.

In closing, I would like to commend again the authorities' program performance to date and their commitment to deepen Romania's adjustment process in the future.

I support the proposed decision.

Miss Vori made the following statement:

In the midst of the comprehensive program of reform of the Romanian economy, the evaluation of the results achieved thus far is somewhat mixed. While the authorities have maintained a disciplined fiscal policy and a tight monetary stance, inflation has not receded as substantially as anticipated, and economic activity has further declined. Recent developments show that all end-September performance criteria have been met, and there have been some positive signs in the external sector, as exports have been higher than expected. However, the economic situation remains difficult, as indicated by the slowdown in the pace of the privatization process and the lack of success in substantially reducing interenterprise arrears. I shall point out a few areas of concern that may undermine the current effort to proceed with the stabilization and transformation of Romania into a market economy.

In spite of the restraint of monetary and credit policy, inflation has been resilient. The growth rate of consumer prices in September was 10 percent, following high rises in early 1992 associated with the effect of the exchange rate depreciation, and again in May as a consequence of the liberalization of some subsidized consumer goods. The authorities have refrained from revising periodically the wage indexation coefficient, which has been kept fixed at 0.5 since November 1991, thus limiting the inertia effect on inflation. However, the persistence of inflation may reflect difficulties in adjusting relative prices, as liberalization in the prices of some administered goods has proceeded at a staggered pace. The authorities are urged to complete the process of price liberalization and to speed up the privatization of the economy. Ultimately, privatization represents the only effective means of solving the endemic problem of interenterprise arrears. It is particularly worrisome that arrears have re-emerged after the authorities had made a first attempt to cope with them through monetization. Even though the increase in total credit including all net arrears has been well below the programmed level, failure to cope with the arrears problem could eventually endanger the credibility of monetary policy by making it difficult to respect monetary control limits and by undermining the effect of tight credit policy.

Concern in the area of fiscal discipline arises from the outcome of company tax collection, which has amounted to only 53 percent of the planned target due to the very low level of industrial production. Unfavourable prospects for the development of fiscal revenues may make it necessary for the Government to consider contingency measures to constrain government expenditures. In particular, expenditures on consumer and producer subsidies, which have been revised upwards for 1992, will have to be curbed and eventually phased out.

Finally, developments in the external sector have been favorable thus far, as the export performance has remained strong while imports have been contained. However, exports to the United States, which have declined by a factor of 4 in the past four years and which currently represent only 3 percent of total exports, will be further harmed by the failure of Romania to obtain most-favored-nation (MFN) status from the United States. The serious problems with the crop harvest also affect the prospects for a strong agricultural export performance. Comments from the staff on the external trade outlook for Romania would be appreciated.

With these comments, this chair supports the proposed decision.

Mr. Zoccali made the following statement:

As I share many of the comments of earlier speakers, I will confine my remarks to a few points of emphasis.

Romania continues to make consistent, albeit slow, progress in its simultaneous pursuit of price stabilization and economic transformation. Since the beginning of the current stand-by arrangement, significant reforms aimed at the liberalization of prices, the trade regime, and the exchange system have taken place. While inflation is still excessively high, it is on a downward trend, and all of the program targets for June and September have been met.

Notwithstanding these achievements, the continued output loss after three years of significant contraction is, as other speakers have mentioned, a cause for concern, as more generalized social tensions would tend to weaken public support for the program. I am heartened by Mr. Posthumus's remarks in this regard following his opening statement. While it should not come as a surprise that the reform process is often contractionary in its initial phase, I very much share the observation of Mr. Posthumus in his opening statement that the slower than envisaged provision of external financing has made adjustment more painful. Balance of payments fragility calls for timely international assistance as well as market access to advance the agenda of reform.

This being said, the re-emergence of interenterprise arrears represents an important setback in the authorities' drive to control the public finances and inflation. Like other Directors, I consider that monetary restrictiveness should not be the sole, or even the main, policy instrument for addressing this continuing disequilibrium. Given that these arrears amount to approximately 20 percent of GDP in the case of Romania, I very much agree with the staff's recommendation that the authorities should apply Law 76 forcefully against defaulting or insolvent enterprises so as to ensure that arrears do not sabotage the program. In addition, I believe that, for the institutional mechanism of privatization to be effective, the early transfer of management of those enterprises deserves greater emphasis. Thus, I welcome the introduction of fixed-term management contracts to speed up restructuring and divestiture.

In a related area, I note with satisfaction that much of the land belonging to agricultural cooperatives has already been distributed to farmers. The staff has mentioned that the supply response has not been favorable owing to the drought and the breakup of land holdings. In my view, the expeditious distribution of land titles should be emphasized in order to create a market for productive land, and I welcome the authorities' intentions in this regard. I would also appreciate some clarification from the staff whether the lack of available financing for agricultural production is, in fact, the major cause for the sectoral production declines.

Finally, as important challenges remain, the continued provision of adequate financial and technical assistance by the Fund remains essential to complement Romania's commitment to the process of economic transformation. I support the proposed decision.

Mr. Prader made the following statement:

Progress thus far toward macroeconomic stabilization is encouraging; all performance criteria, for both end-June and end-September, have been met. The outlook for the year as a whole is less promising; output still remains 30 percent below the level in 1991, annual inflation is expected to exceed the program target, and Romania's reserve position remains fragile. The authorities must maintain tight macroeconomic policies and speed up the elimination of the severe structural obstacles to stabilization.

The authorities intend to pursue strict monetary and fiscal policies and a firm wage policy during the rest of the program. If the economy continues to decline, it will require strenuous efforts to hold the fiscal deficit to no more than 2 percent of GDP. We applaud the additional revenue measures, particularly the recent measures to collect tax arrears, but we would have preferred to see more balanced actions, including further corrective fiscal measures. Warning signs of an erosion of turnover and profit tax receipts should be met with a more comprehensive fiscal restructuring. We agree with the staff on the need to eliminate the still high consumer and producer subsidies. This would streamline expenditures and further reduce the economic role of the state. The preparations for introducing the VAT in 1993 are welcome, and we urge the authorities to accompany the VAT with a reliable income taxation system. Could the staff provide some information on progress with the agricultural income tax that was scheduled to be introduced by the middle of the year?

Containment of inflation will require continued vigilance over monetary developments and incomes policy. Despite the recent sharp declines in monthly inflation, the staff is right to warn against any premature relaxation of these policies. To meet the ambitious target of a monthly inflation rate of 1-2 percent by year's end, the authorities must keep real interest rates positive and be ready to tighten monetary policy still further.

The continued accumulation of interenterprise arrears is discouraging and threatens to undermine the tight monetary policy. The authorities must vigorously enforce the recently adopted bankruptcy law and the measures for taxing interenterprise credits. The recent measure allowing the Government to intervene directly to eliminate the arrears is needed and has our full support. Tight monetary control is also crucial for the maintenance of exchange rate stability, as the rate is now determined by market forces and can only be supported by the Government through the maintenance of tight financial policies.

A few words on wage policy. In my view, indexation can be a short-term measure to control wage developments, but for the longer term one should aim at introducing some form of collective bargaining. As long as the current system is in place, however, it should be adhered to. In particular, a stop should be put to what has been happening with increasing frequency in recent months, namely, the increases in fringe benefits and other forms of additional remuneration in those enterprises whose workers are in a strong bargaining position. Lax policies in this area undermine the whole stabilization effort.

Let me now turn to the external sector, which is still very precarious despite some positive developments in the recent past. We strongly welcome the de facto unification of the exchange rate in the summer of 1992. However, we are alarmed by the steep drop in the exchange rate. With hindsight, it might have made sense to safeguard the flexible exchange rate system through some renewed regulation on the trade side, as I pointed out at the May discussion on Romania's request for a stand-by arrangement (EBM/92/68, 5/29/92). The fact is that both exports and imports have been extremely inelastic to a leu depreciation that was much more pronounced than the staff anticipated. If we compare the figures for the initial and revised programs, we see that 1992 imports were estimated at $5.1 billion in both versions of the program, while exports were estimated to be $3.9 billion in the initial program but $4.1 billion in the revised program. From this observation, it is obvious that the exchange rate has so far had no significant effect on trade developments.

On the export side, of course, this is just one more manifestation of the very slow supply response. On the import side, the inelasticity suggests two things. First, a further compression of imports of energy, raw materials, semi-finished products, and, in the medium term, investment goods seems impossible without significantly depressing economic activity further in Romania. Second, curbing the import of consumer goods can only be done through prudent financial and wage policies supplemented, as I have suggested, by some form of strictly temporary trade measures.

Unfortunately, Romania's exchange rate system has imported a good deal of inflationary pressure, which will reveal itself once the domestic prices of energy and raw materials, still largely under state control, are brought into line with world prices. As this alignment began only last September, it is still too early to see the full effect of the leu depreciation on inflation.

While there has definitely been progress in the area of external financing, the staff paper may be overoptimistic concerning the assumed pace of disbursement of G-24 balance of payments support in the near future. This being so, Romania may not succeed in reaching by year's end a reserve level of $7 million, equivalent to seven weeks' imports, a level that would be low by any standard. Moreover, I wholly agree with the staff's medium-term outlook that at best, Romania will have significant current account deficits, "which underscores the need for continuous access to external finance," namely, at least over the next five years. To my mind, the long-term nature of Romania's financing need--even if the transformation process eventually succeeds--has yet to be fully understood.

I support the proposed decision.

Mr. J. E. Ismael made the following statement:

Important progress has been made to achieve the objectives of the 10-month stand-by arrangement. In particular, strict monetary policy and cautious wage indexation have reduced inflation to a manageable monthly rate of 3 percent in recent months. Notable improvements have also been made in reducing consumption subsidies and in promoting exports to convertible currency areas. Privatization of agriculture, housing, and small service establishments has also been accelerated.

On the other hand, it has to be pointed out that some unwelcome slippages have also occurred, which, if not remedied in time, would jeopardize the good results achieved in other areas of the stabilization and structural reform. The most disturbing of these developments, which has also been mentioned by earlier speakers, is the re-emergence of interenterprise arrears. This quasi-credit expansion as a result of the lack of financial discipline among state enterprises would serve to negate the prudent measures in other areas of fiscal and monetary policies. In this connection, I welcome the recent enactment of a new law to enforce financial discipline in state enterprises, and I would urge the authorities to apply the law promptly and forcefully. In the meantime, I can also support the staff suggestion that market-based interest rates should be imposed on interenterprise credits. To put an end to this major impediment to successful stabilization, I would also encourage the authorities to speed up the process of privatization of large state enterprises.

Other areas where extra efforts are needed include further reductions in consumer and producer subsidies, as well as solving the problem of tax arrears.

In conclusion, I welcome the resolve that has been demonstrated by the authorities in staying on course despite the many difficulties that they have to overcome, and their renewed commitment to the program objectives and performance targets. I can support the proposed decision.

Mr. Solheim made the following statement:

Like previous speakers, I want to commend the Romanian authorities for firmly adhering to their comprehensive program of economic reform and adjustment. All end-September performance criteria were observed, and the Government appears to have resolutely stayed the course with the 1992 program.

Despite the firm implementation of the reform program, the economic performance remains mixed. Economic activity shows no signs of recovery, inflation remains much too high, and unemployment is rising. The strong growth of exports represents, on the other hand, a positive sign, and it may indicate that the restructuring of the Romanian economy is starting to bring the expected benefits.

Romania is now in its third year of transition from a centrally planned economy to a market-oriented economy. The experience of Romania--as well as other previously centrally planned economies--shows that it takes time to reap the fruits of the reform efforts. The virtual collapse of trade with the countries of the former Soviet Union, as well as the weak economic development in industrial countries, have certainly not made the transformation process easier. Nevertheless, it is essential that the authorities remain committed to the present stance of their economic strategy.

The staff paper underlines the fact that interenterprise arrears remain a serious financial problem. It is welcome that the authorities have put in place a system to monitor, on a monthly basis, the financial situation of state-owned enterprises and have enacted a new law to enforce the financial discipline of enterprises. I also welcome the new measures outlined by Mr. Posthumus in his extended remarks. Given the lack of an efficient payments system, and with a high nominal interest rate, the incentive to accumulate interenterprise arrears will remain strong. However, as pointed out by the staff representative, a major reason for this problem seems to be the state-owned enterprise system, and further privatization reforms are therefore strongly needed. As stated in the staff paper, insufficient progress in enterprise reform appears to be the principal weakness in the transformation of the Romanian economy.

With larger than anticipated capital inflows, the balance of payments situation may not represent a major problem in 1992. However, shortfalls in official financing have occurred in many instances, partly due to delays in disbursements of World Bank and related Japanese financing. I agree with previous speakers that such delays are detrimental to the adjustment efforts of the country, which deserves strong international support. The staff representative has already touched upon the reasons why the World Bank loans have been delayed, but I would appreciate comments from the staff concerning the reason for delays of disbursements from other sources.

In conclusion, I fully support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

The Romanian authorities deserve strong commendation for their determined implementation of the 1992 program despite significant external and internal difficulties. I am encouraged by the fulfillment of all end-June performance criteria and the positive outcome for the third quarter of 1992 indicated in the statement by the staff representative. Nevertheless, I am concerned by the continuous decline in output and the higher than expected inflation. This clearly illustrates the need to accelerate enterprise reforms and maintain tight financial policies.

The fiscal outcome in the first half of 1992 was broadly satisfactory, despite minor slippages in turnover and profit tax that were more than offset by better than programmed performance in other taxes and slight overruns in current expenditures. Nonetheless, the nominal fiscal target for June was achieved. Moreover, the authorities' commitment to the agreed fiscal target for 1992 was buttressed by the adoption of additional fiscal measures that are expected to improve the budgetary outlook by 1.3 percent of GDP. I am also reassured that the authorities are willing to further curtail expenditures, should the need arise.

Turning to monetary policy, I am troubled by the apparent difficulty in interpreting monetary developments, owing in part to the re-emergence of interenterprise arrears. In this regard, I welcome the enactment of Law 76, which, it is hoped, will allow the authorities to control and eliminate interenterprise arrears. Also, I endorse the authorities' reluctance to undertake another global compensation operation.

Nevertheless, the persistence of interenterprise arrears, coupled with an unstable demand for money, as illustrated by the volatile and high velocity of broad money, raise serious concerns regarding the role of monetary policy as the nominal anchor of the program. While I recognize that, with limited foreign exchange reserves, the exchange rate cannot be used as a nominal anchor, it should be viewed as an indicator of the effectiveness of the nominal anchor. Consequently, the dramatic depreciation of the exchange rate between June and September 1992 is worrisome, especially given the significant impact of exchange rate movements on inflationary expectations. Therefore, the authorities need to exercise caution in determining their targets for the expansion of net domestic assets, with a view to reducing, if necessary, these targets in order to achieve the inflation objective.

With these remarks, I support the proposed decision.

Mr. Kanada made the following statement:

The Romanian authorities have continued to implement the stabilization and structural policies with the aim of achieving the targets of the macroeconomic program for 1992. It is welcome that strenuous stabilization and structural transformation efforts were made despite the difficult circumstances and that all the end-September performance criteria were observed, as mentioned in the statement of the staff representative. In light of the current weak economic situation and the deteriorating outlook for the coming year, further measures should be taken to stabilize the economy.

A revenue shortfall is projected for the second half of 1992, owing to the decline in output and the accumulation of inventories. In this connection, it is welcome that taxes, including excise taxes and stamp duties, were increased. Also, it is expected that a VAT will be implemented as early as possible in 1993. In order to curtail expenditures, it will be necessary to cut subsidies further.

There has been some success--a little more than in the beginning of the year--in reducing inflation thanks to the implementation of the strict monetary policy, including tight credit and positive real interest rates, and the wage policy. As inflation is now expected to reach about 150 percent for the year as a whole, compared with 115 percent in the original program, the continuation of the incomes policy is imperative in order to achieve the inflation target.

On the structural front, there has been substantial progress in privatization through measures such as the transfer of a small proportion of the share capital of state-owned enterprises to the private sector and the distribution of land to private farmers. However, in light of the recent re-emergence of interenterprise arrears, it is necessary to press forward with further privatization and enterprise restructuring, including allowing for bankruptcy proceedings for inefficient public corporations.

On the distribution of land to farmers, like Mr. Zoccali, I would be interested in the staff's assessment of whether land distribution will lead to increased output. Also, I would like to know whether ownership can be established without land titles, because, according to the staff paper, the issuance of titles is proceeding slowly.

Finally, on the external front, there has been a surplus in the overall balance of payments owing to a smaller than projected current account deficit in 1992 and favorable financing. However, an increase in exports is a key element for the achievement of a favorable economic performance, and it is necessary to make further efforts to promote exports, as the amount of financing in 1993 is not known. In this connection, I would like to ask the staff what it thinks the leading export industries should be.

With these comments, I support the proposed decision.

Mr. Glazkov made the following statement:

There is no need to go into detail about the many common features of Russia's and Romania's difficult and complicated processes of transition from centrally planned to market economies. Therefore, it was a genuine pleasure to learn from the staff paper that Romania's economic policy has been successful and to note the highly positive role of the Fund in the transformation process of this country.

Romania's economic situation is one of the most difficult of the former socialist countries, and this country is pursuing the twin goals of macroeconomic stabilization and structural transformation in the face of considerable difficulties. It is truly impressive that, in spite of all the complications, the Government has managed to bring down inflation, by 3 percent in September 1992, and that the fiscal deficit this year will be no more than 2 percent of GDP. No less impressive is the authorities' success in meeting the target for the current account deficit, which will be $0.1 billion less than the original target of $1.3 billion.

Among the main achievements that must be mentioned are the fact that the impressive financial results were achieved in spite of a serious decline in production; the authorities are imposing strict policies on state enterprises to reduce interenterprise arrears; and the Government and the National Bank of Romania are working closely together in implementing tight monetary and fiscal policies.

Perhaps the most impressive feature of Romania's performance thus far is that the authorities have managed to do all of this while facing a strong political struggle and a certain amount of instability of state power during 1992. We do not think that there can be a 100 percent guarantee of further progress in the process of stabilization and structural transformation in Romania. Much will depend on the Government's ability to overcome the existing difficulties and threats that still remain; in particular, economic activity remains weak in spite of a slight improvement over the past few months, and the interenterprise arrears problem is still far from being solved. We doubt whether these two challenges can be easily met, especially when taking into account the very limited progress in privatizing the state enterprises.

Also, the forthcoming tax reform in 1993 will probably not be as difficult as it was in Russia, but I think it is going to be more complicated than the approaching Czechoslovak tax reform and may lead to a substantial revenue shortfall in the beginning of the year.

The main concern is whether the Romanian Government is truly committed to further pursuing tight fiscal and monetary policies and to implementing a deep structural transformation. We know well that it is much more difficult to achieve such a transformation than to achieve spectacular but short-term results.

With these comments, I support the proposed decision, and I hope that Romania will, in fact, benefit from continued international support.

Mr. Marino made the following statement:

We are pleased to find that, according to recent data provided by the Romanian authorities, all end-September performance criteria have been observed. Nevertheless, the results of the program so far in 1992 have been mixed. Economic activity has continued to fall--30 percent below the level in the same period of the previous year, although it rebounded in August-September by about 7 percent--and the initial program target has had to be revised. The target for inflation is also expected to be exceeded. Yet, there has been some success in bringing down the sharp rise in consumer prices of early 1992 following the large depreciation of the leu and some cuts in subsidies.

Both the external current account deficit and the overall balance of payments are broadly in line with program targets, and gross international reserves have increased, in line with the program, despite delays in disbursements from official sources. The fiscal deficit target for June was met, and a strict credit policy was implemented by the National Bank of Romania, while tax and interenterprise arrears surged. Although private sector employment increased significantly, total employment declined, reflecting the industrial output downfall.

The Romanian authorities are facing difficult times in their pursuit of macroeconomic stability. The Romanian Government's efforts to bring arrears and inflation down are remarkable, as is its firm intention to keep the fiscal deficit in line with the target of no more than 2 percent of GDP for 1992. However, as the staff outlines, in addition to the measures to increase revenues, it may be necessary to implement further expenditure cuts in order to meet that goal. The efforts to reduce inflation, and to implement tight monetary and wage policies, have to continue as long as the inflationary cycle has not completely settled down.

We are in support of the authorities' commitment to resist any premature relaxation of these policies, acknowledging the social problems associated with the transformation process. It should be strongly pointed out, however, that further progress in stabilization may depend to a certain degree on enterprise reform. Unfortunately, there seems to be insufficient progress in this area. The privatization of large enterprises should be speeded up. Without this, the success of the program under current circumstances is uncertain. Implementing only macroeconomic policies and enacting new economic laws may prove insufficient given the lack of strong economic agents that are responsive to market forces. Without accelerating enterprise reform, the authorities may face after some time a difficult option: either strengthening stabilization policies with painful social consequences, or considering a slower pace of economic reform.

With these remarks, we support the proposed decision.

Mr. Murphy made the following statement:

Like other speakers, I welcome the apparent commitment of the authorities to achieve the objectives of transition to a market-based economy.

Given the critical role of privatization of large state enterprises in the reform process, we have a concern about the slow pace of privatization, and we wonder in particular how feasible it will be to effect a reduction of 10 percent a year in the remaining 70 percent of holdings of the State Ownership Fund. We also have a concern about the apparent absence of substantive moves toward commercialization, to accompany privatization. However, in this regard, the announcement of fixed-term management contracts in some sectors is a welcome development.

The staff urges the authorities to implement policies to reduce interenterprise arrears through a tax policy to induce the charging of market-based interest rates on interenterprise credits. The latest move to deal with the outflows involves a command-type measure, embracing direct intervention by the state as owner, to require a reduction of arrears. I wonder about the appropriateness of the apparent switch from an incentive-based approach.

Finally, while we welcome the efforts to reignite trade, we have some concerns that, with subsidies still high relative to other transforming economies, old trading patterns will be reinstated and the benefits of Romania's comparative advantage will not be exploited fully.

The staff representative from the Research Department said that he could agree with Mr. Esdar and others that there might have been some overshooting of the exchange rate. As Mr. Esdar had pointed out, however, the authorities had no choice but to let the exchange rate adjust; without sufficient reserves, there was no credible way of using the exchange rate as a nominal anchor. The authorities had repeatedly indicated that they would defend the exchange rate when they had sufficient reserves to do so, as they agreed that Romania would benefit from a stable exchange rate to achieve and maintain a low rate of inflation.

The recent steps taken by the authorities to resolve the problem of interenterprise arrears should be seen as only one part of a wide range of measures that were already under way, the staff representative considered. Those measures involved interest rate policy, tax policy, direct intervention in enterprises, and even publicizing the names of enterprises that were in arrears. As interenterprise arrears had no single cause, only a range of complementary measures would be effective in solving the problem.

One of the important lessons of Romania's reform program was that the liberalization of prices in stages would lead, almost by definition, to a persistence of inflation, the staff representative commented. In fact, the authorities recognized that, in retrospect, their multistaged approach to price reform had generated more inflation than would have been the case had they raised prices in one step. The periodic large price increases in Romania seemed to have led to an increase in inflationary expectations, which were often self-fulfilling. Those expectations were still prevalent, in anticipation of the final stage of price liberalization in 1993, and there was still evidence of some inertial inflation in Romania even though the growth of wages had been controlled fairly well.

It had been expected that agricultural output would fall in the short run following the land reform, the staff representative from the Research Department said. In part, the output decline was a result of the nature of the transfer process itself, which, rather than transferring land direct from state collectives to farm workers, provided for the return of land to families whose land had been confiscated after the Second World War. The process was problematic in the sense that, owing to the slow distribution of land titles, many landowners could neither sell land--to accumulate larger, more efficient holdings--nor obtain credit, using the land as collateral, and thus begin to work it. The problem was compounded by the fact that many prewar landowners had been living in the cities for one or even two generations and could not easily sell their land to those who were willing and able to cultivate larger land holdings.

Mr. Posthumus remarked that most Directors had referred to the problem of interenterprise arrears, which was not surprising given that they were central to the larger problems of the transformation process. If the transformation process advanced quickly, then unemployment would increase and there would, perhaps, be less inflation; if it went slowly, however, then there would be no noticeable increase in unemployment.

Directors also discussed at length Romania's financial situation, particularly its external financial situation, Mr. Posthumus recalled. In his view, Romania's difficulties in that regard had been, and would continue to be, exacerbated by the link between the financing commitments of one group of donors and those of another other group of donors. That kind of arrangement could only delay the disbursement of needed financing and should be reconsidered.

He agreed with Mr. de Groote's observation at that morning's discussion on Czechoslovakia, Mr. Posthumus commented, namely, that it would be helpful for the Board not to use such phrases as "shock therapy," as such characterizations often posed difficulties for the governments of the countries concerned. By the same token, however, abandoning the use of such evocative phrases should also have the positive effect of obviating the need for those governments to issue somewhat defensive statements about their "gradualist" approach to stabilization and reform. The overuse of both phrases might help to explain the differences between the report in the recent edition of the Morning Press and the program itself.

The Chairman remarked that he fully agreed that the link between the contributions of one group of donors and those of another group of donors in support of the reform efforts of Eastern European countries had been harmful, especially in the case of Romania. With respect to interenterprise arrears, the lesson from Romania's experience was that determined action to eliminate such arrears was essential to avoid severe difficulties in both the fiscal and monetary areas. In that regard, he had been impressed by the authorities' plans to apply the newly adopted law on financial discipline, as well as by the other measures they were taking to address the problem.

The Executive Directors took the following decision:

1. Romania has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Romania (EBS/92/79, Sup. 1, 6/5/92) and the final paragraph of the letter of May 4, 1992 from the Minister of Economy and Finance and the Governor of the National Bank of Romania.

2. The letter of the Minister of Economy and Finance and the Governor of the National Bank dated September 14, 1992 shall be attached to the stand-by arrangement, and the letter of May 4, 1992 with attached memorandum shall be read as supplemented and modified by the letter of September 14, 1992.

3. The Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement for Romania is completed.

Decision No. 10193-(92/137), adopted
November 16, 1992

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/136 (11/13/92) and EBM/92/137 (11/16/92).

3. REPUBLIC OF KAZAKHSTAN - REPRESENTATIVE RATE FOR RUSSIAN RUBLE AS CURRENCY OF KAZAKHSTAN

The Fund finds, after consultation with the authorities of the Republic of Kazakhstan, that the representative rate under Rule 0-2(b)(i) for the Russian ruble (as currency of Kazakhstan) against the U.S. dollar is the midpoint between buying and selling rates for the Russian ruble against the U.S. dollar in the interbank market, as ascertained by the Central Bank of Russia. (EBD/92/271, 11/10/92)

Decision No. 10194-(92/137) G/S, adopted
November 13, 1992

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/92/86, Supplement 1 (11/12/92) and EBAM/92/117 (11/12/92) is approved.

APPROVED: May 11, 1993

LEO VAN HOUTVEN
Secretary