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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/32

10:00 a.m., April 8, 1994

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

M. Camdessus, Chairman
R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
M.-A. Autheman	P. Cailleteau, Temporary
	D. Desruelle, Temporary
J. Bergo	A. Törnqvist, Temporary
H. Evans	J. Dorrington
H. Fukui	T. Fukuyama
	T. Oya, Temporary
K. P. Geethakrishnan	L. E. N. Fernando
	N. Prasad, Temporary
	Hon C.-W., Temporary
D. Kaeser	K. Link
A. Kafka	A. Calderón
K. G. Kagalovsky	B. M. Lvin, Temporary
W. Kiekens	J. Prader
	T. Isataev, Temporary
G. Lanciotti	N. Coumbis
	M. Giulimondi, Temporary
K. Lissakers	M. W. Ryan, Temporary
	G. Torres
A. Mirakhor	H. Golriz, Temporary
	S. Rouai, Temporary
	B. S. Dlamini
G. A. Posthumus	O. Havrylyshyn
	J.-C. Obame, Temporary
S. Schoenberg	E. Wagenhoefer
	G. M. Blome, Temporary
A. S. Shaalan	Y. Y. Mohammed
	G. F. Murphy
	N. L. Laframboise, Temporary
	K. J. Langdon, Temporary
	A. M. Tetangco, Jr.
	Wei B.
A. G. Zoccali	N. Mancebo, Temporary

L. Van Houtven, Secretary and Counsellor
A. Leipold, Acting Secretary
M. J. Miller, Assistant
R. I. Vera-Bunge, Assistant

Also Present
IBRD: S. K. Otoo and P. J. Siegelbaum, Europe and Central Asia Regional Office. Central Asia Department: G. M. Meredith. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; C. J. Bismut, E. V. Clifton, B. Drees, J. H. Green, G. G. B. Henry, S. G. Lipworth, I. Otker, T. M. Reichmann. European II Department: W. W. Camard, A. Cheasty, M. De Broeck, L. Hansen, D. G. Jones, A. Kammer, A. Knobl, V. R. Koen, A. K. Lahiri, A. Lellep, T. J. Richardson, T. O. Saavalainen, G. H. R. Tersman, J. R. Wein, T. A. Wolf, B. B. Zavoico. External Relations Department: G. Hacche, J. E. McEuen. Fiscal Affairs Department: S. K. Chand, P. Doyle, J. Escolano, A. G. A. Faria, A. Jaeger, M. Z. Yucelik. IMF Institute: P. B. de Fontenay, Director. Legal Department: R. B. Leckow. Middle Eastern Department: P. Chabrier, Director. Monetary and Exchange Affairs Department: B. Vollan. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, A. Basu, S. A. Coorey, S. Y.-L. Jen, A. K. McGuirk, A. Singh. Research Department: M. Mussa, Economic Counsellor and Director; B. B. Bakker, D. T. Coe, R. A. Feldman, R. P. Ford, S. J. A. Gorne, M. Hargraves, A. Hoffmaister, F. Larsen, S. H. Samiei, G. J. Schinasi. Secretary's Department: J. W. Lang, Deputy Secretary; A. Mountford. Southeast Asia and Pacific Department: R. G. Carling. Statistics Department: A. Bloem. Treasurer's Department: L. U. Ecevit, H. Flinch, K. M. Kenney, M. A. Wattleworth. Western Hemisphere Department: S. T. Beza, Counsellor and Director; C. M. Towe. Office of the Managing Director: P. R. Narvekar, Special Advisor; G. R. Saunders, Personal Assistant. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, R. F. Cippa, S. K. Fayyad, T. K. Gaspard, G. Y. Glazkov, J. M. Jones, Y.-H. Lee, M. F. Melhem, P. A. Merino, R. Meron, A. Raza, B. A. Sarr, N. Toé, Yang X. Assistants to Executive Directors: S. Al-Huseini, R. N. A. Ally, S. Arifin, M. C. B. Arraes, D. A. Barr, P. I. Botoucharov, M. A. Brettschneider, J. M. Burdiel, A. Cathcart, J. A. Costa, C. D. Cuong, M. Dzervite, G. El-Masry, J. C. Estrella, M. Fein, A. Galicia, M. A. Hammoudi, S. Ishida, A. M. Koulizade, K. Kpetigo, V. Kural, J. Mafararikwa, G. J. Matthews, F. Moss, J. A. K. Munthali, H. Petana, R. K. W. Powell, N. Prasad, T. Sitorus, L. Tase, A. Viirg, J. B. Wire, Wu H.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Coumbis to the Executive Board as Alternate Executive Director for Albania, Italy, Malta, Portugal, San Marino, and Greece.

2. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/94/31, 4/6/94) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/94/50, 3/14/94), together with a statistical appendix (EBS/94/51, 3/14/94) and boxes and annexes providing supplementary material (EBS/94/56, 3/17/94). They also had before them a report on recent developments in the management of the debt situation (EBS/94/59, 3/22/94; and Cor. 1, 4/5/94) and a paper on economic implications of unproductive public expenditures (EBS/94/69, 3/31/94).

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

> I would like to acknowledge the many interesting suggestions made by Directors regarding possible extensions of the analysis in the World Economic Outlook. Some of these suggestions can be addressed in the current World Economic Outlook. We will need some more time to reflect on many other issues that were raised, but I have no doubt that we will be able to address many of them in future world economic outlook exercises.
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> Mr. Evans reminded us about the difficulties the Fund and other official and private forecasters have experienced during the recent recession in forecasting the depth of the downturn. The staff agrees that a point forecast is not very helpful in conveying the margin of uncertainty that attaches to the forecast. Indeed, our postmortem analyses of our forecast record clearly illustrate that the confidence interval around the central forecast is relatively large. It would probably not be helpful, however, and I very much doubt that it would be feasible, to indicate a confidence interval around each and every projected number in the World Economic Outlook. What we try to do instead is to draw attention to the potential risks in the outlook and, most important, to formulate the policy advice in such a way that it takes appropriate account of these risks. On some occasions, we have included alternative scenarios to illustrate the implications if these risks were to materialize. I nevertheless think that Mr. Evans made an important point about the need to pay attention to these issues, and the staff will reflect on how we might better convey the notion of forecast uncertainty in future World Economic Outlooks.

Mr. Evans also cautioned against excessive optimism in the medium-term projections for the developing countries, and Mr. Fukui questioned the realism of the projected growth rates for Africa. In this context, I would like to stress an important forecast convention used by the staff: that the projections are based on currently announced policies, including those implied by existing Fund-supported stabilization and adjustment programs. Consequently, any significant policy slippages could well produce a different result. The bias that may be introduced as a result of this convention is very small, however, and the impressive adjustment efforts of a large and rapidly growing number of developing countries does seem to justify a degree of optimism in the projection. As Mr. Ahmed put it, the impressive growth record of much of the developing world could be viewed as signaling a new era in economic relations between industrial and developing countries.

Here, I would like to mention the contributions to the growth of world trade last year. Overall, world trade rose by about 2.5 percent in volume terms in 1993. The net contribution of the industrial countries to that growth was essentially zero, or in any case negligible, even taking into account the likely underestimate of trade flows within the European Union in 1993. Therefore, the whole growth in world trade in 1993 of 2.5 percent comes from the rapid expansion of developing country imports and exports.

Developing countries' imports rose by about 10 percent in 1993, providing, of course, important new and growing markets for developing countries themselves, as well as for many industrial countries, thereby helping to cushion the recession in the industrial countries.

Mr. Smee mentioned the need to use the expansion wisely, which raises a host of interesting medium-term policy issues which we undoubtedly will come back to in coming discussions. A particularly critical issue concerns the medium-term fiscal requirements, where Mr. Posthumus, Mr. Schoenberg, and Mr. Autheman felt that the present World Economic Outlook could have said more, although I believe that they shared the analysis that is presented. Of course, medium-term fiscal issues, including the budgetary consequences of an aging population, were treated extensively in last October's World Economic Outlook. On this occasion, the staff has given somewhat greater emphasis to labor market issues, which seems particularly relevant in light of the sharp rise in unemployment in many countries in recent years. We have also discussed monetary policy issues in greater depth than usual, which we feel is justified by the divergence in policy experiences across countries. However, the scale of the fiscal imbalances across countries suggests that we will have many opportunities to revisit fiscal policy issues in the future.

Mr. Evans and Mr. Obame suggested greater emphasis on the need for timely and realistic debt-reduction agreements for low-income countries with unsustainable debt burdens. This issue is already mentioned in the paper, but we will look again at the various sections and add references to this issue where appropriate.

Mr. Wei, Mr. Fukui, Ms. Lissakers, and Mr. Tetangco referred to the impressive experience of the dynamic Asian economies as examples of economic development strategies that could receive greater emphasis. The experience of these countries was, of course, quite prominently highlighted in recent world economic outlook papers that focused on the successfully adjusting countries. In this issue of the World Economic Outlook, we have made an effort to analyze the experience of the less successful countries, and have consequently paid less attention to the Asian countries' performance. However, future World Economic Outlooks will surely again review the experience of the Asian economies. Several Directors specifically suggested the inclusion of case studies to make the World Economic Outlook less general. We agree with this suggestion, of course, and recent World Economic Outlooks have, in fact, included a couple of case studies in the form of boxes on specific countries. I would also note the case study in Annex III in the present World Economic Outlook, which discusses the experience of countries in Latin America and the Caribbean since the onset of the debt crisis. It is our intention to build on these experiments and include similar case studies in future World Economic Outlooks. At the same time, we need to strike an appropriate balance between such case studies and the need for cross-country analyses, which, after all, are probably the comparative advantage of the World Economic Outlook.

Ms. Lissakers, Mr. Autheman, and several other Directors suggested a need to expand the policy analysis in the chapter on transition economies. As this topic will be discussed by the Board next week, I believe, it is difficult for the World Economic Outlook to do full justice to the outcome of that discussion--which may also require further reflection--but we will keep these suggestions in mind for future World Economic Outlooks. For now, we will follow Mr. Autheman's advice and take another look at the consistency between the policy analysis and the policy conclusions in that chapter.

Also on the transition countries, Mr. Posthumus and several other speakers referred to Table 17 and page 84 of the World Economic Outlook. We will, of course, adjust the text to make it as precise as possible and to avoid misunderstandings about the nature and origin of the financial assistance.

Mr. Kafka suggested that the World Economic Outlook should have paid more attention to capital inflows, as it did in the October World Economic Outlook, and to the related policy issues. This is undoubtedly a topic to which we will return in the near future, and where we could make an attempt to deal with the interesting and difficult issues regarding capital controls raised by Mr. Kafka, Mr. Zoccali, and Mr. Al-Jasser. Here we would draw on recent staff studies, including in particular Occasional Paper No. 103 issued a year ago that looks at the experience with capital controls.

With respect to the discussion on the outcome of the Uruguay Round, many Directors suggested that the important benefits should be given more prominence in the World Economic Outlook, and the staff obviously agrees with this. We have been working on various suggestions that were made, in particular by Mr. Posthumus, and the suggestion we have is to highlight these benefits in particular in Chapter 1. Chapter 1, as the overview chapter and the basis for the forthcoming press release, is probably the most appropriate place to insert a reference to the global benefits of the Round. We intend to replace the existing second paragraph with a more extensive discussion of the various benefits, where we will highlight that the outcome of the Round will considerably enhance trading opportunities for all groups of countries; that it will give new impetus to trade in manufactured goods and in services; that it will begin to reduce the serious distortions affecting trade in agricultural products and the heavy costs of agricultural subsidies in many countries; and that it will strengthen multilateral trade rules and extend them to many new areas, in addition to reducing tariff and nontariff barriers in many sectors. We would also mention that the creation of the World Trade Organization (WTO) signals a new approach in trade relations among countries which would help sustain the achievements of the Uruguay Round and provide a focus for future multilateral trade negotiations. We would, of course, refer in summary to the quantitative estimates that are mentioned in more detail in Annex 1. We would emphasize that such global welfare benefits will materialize gradually as the main elements of the Round are phased in, that the agreement also has to be ratified by governments--and that this is a major downside risk to the near-term outlook--and that the agreement should bolster business and consumer confidence worldwide in the period ahead and thereby contribute to global recovery.

Mr. Posthumus had suggested that Annex 1 could be dropped given this expansion, but I think that Annex 1 does contain a number of interesting details, both about the broad outline of the agreements that have been reached, and also about the various studies, and the caveats attaching to these studies, that have been made about the effects of the Round. Thus, I think that Annex 1 serves a useful purpose, in addition to the strengthening of Chapter 1.

We will also look again at the text of Chapter 2 to make sure that the confidence aspects and the contribution to the outlook of the removal of the downside risk now that the Round has been approved are included.

We have looked again at the discussion on the developing countries in Chapter 4. I understand why Mr. Posthumus, in particular, had a problem with that chapter, because it is presented in terms of a general discussion on the impact of the Uruguay Round on the developing countries. It would be relatively easy to refocus that to emphasize in particular the Uruguay Round's possible effects on, and contributions to an improvement in, the trade environment for the low-growth countries--the countries that are the subject of that chapter. Among the various aspects of the trade and external environment, it is relevant to emphasize the benefits of the Uruguay Round, which, of course, will need to be followed up by more effective domestic structural and stabilization policies in order to allow those countries to reap the full benefits. I think that these suggestions give due emphasis to the outcome of the Round, and I hope that they will be acceptable to Directors.

The Chairman remarked that it was important to give the successful conclusion of the Uruguay Round the emphasis it deserved.

Ms. Lissakers said that the staff's suggestions for strengthening the coverage of the Uruguay Round in the World Economic Outlook were exactly on target. It would be useful to have a more detailed explication of the benefits of the Round early in the paper.

She assumed that further analysis of the outcome of the Round would be included in future World Economic Outlooks, Ms. Lissakers remarked. An area of particular interest to her chair would be an examination of the expansion of trade among the developing countries, which might or might not be a direct outgrowth of the Uruguay Round. It might also be useful to look at a number of the regional integration areas in the next World Economic Outlook.

The Chairman responded that those areas could be covered in more depth in future World Economic Outlooks.

The Economic Counsellor and Director of the Research Department noted that separate Board discussions--outside the discussion of the world economic outlook--on regional trading arrangements and related issues were also anticipated.

Another staff representative from the Research Department made the following statement:

A number of Directors commented on the discussion in the World Economic Outlook of unemployment and policies to reduce unemployment. Mr. Al-Jasser asked the staff to comment on whether wages in Europe are too high, as suggested by the proposal in the European Union (EU) White Paper to keep real wage growth below the trend growth in productivity. The high rates of unemployment among young and unskilled workers suggest that labor costs are too high in Europe, at least for some segments of the labor force. This is so even though high and rising unemployment in Europe throughout much of the 1980s was successful in moderating wage growth. It is interesting to note that the EU White Paper also places considerable emphasis on the need to increase investment, even though capital formation was relatively buoyant in Europe during much of the 1980s. While lower labor costs and stronger capital formation can be expected to help reduce unemployment, real wage gaps and capital shortages--both of which were discussed extensively in Europe during the early 1980s as causes of high unemployment--are symptomatic of more deep-seated labor market problems. In the absence of fundamental labor market reform, real wage gaps and capital shortages are likely to remain chronic European problems. In the absence of fundamental labor market reform, we see no reason to believe that the ratcheting up of European unemployment from one recession to the next has come to a halt.

Mr. Al-Jasser also asked about the budgetary costs of training programs. Government-run training programs are not only expensive, but there is also little evidence from the academic literature that they increase the probability that participants will actually become employed. Training appears to be most effective when it is done by enterprises, probably because much of training and many skills are firm-specific. There are, however, recent proposals to use unemployment insurance funds to subsidize firms that provide training to young workers and to those unemployed for long durations. Australia's "Jobstart" program is an example of such a program, and it has been successful in reducing unemployment and the duration of unemployment. These types of programs do not necessarily imply increases in government expenditures, but rather reorient expenditures from passive income support to more active policies that create incentives for firms to provide training and for workers to acquire skills.

Mr. Kiekens interpreted the World Economic Outlook to advocate that labor market reform should wait until after macroeconomic policies have set the stage by establishing a strong recovery. We did not intend the World Economic Outlook to give that message, and we will look carefully at the drafting to ensure that it does not. Our view, as stated in the middle of page 33, is that "if economic policies are to succeed in reducing unemployment on a durable basis, they will have to facilitate the absorption of cyclical unemployment as rapidly as would be compatible with medium-term budgetary and inflation objectives while at the same time addressing the fundamental causes of high levels of structural unemployment." Ms. Lissakers and Mr. Smee are right to emphasize that it may be more difficult to implement reforms during a recession, but macroeconomic policies and labor market reforms can and should be mutually reinforcing; and this is particularly likely to be the case during the expansion that is now in prospect.

Ms. Lissakers suggested that the communiqué from the Group of Seven industrial countries (G-7) jobs summit, which took place after the world economic outlook paper was circulated to the Executive Board, might be usefully included as a box in the published World Economic Outlook. We are open to this suggestion. We will also note in the box on recent labor market reforms in Europe that substantial labor market reforms were undertaken in the United Kingdom during the 1980s, as suggested by Mr. Evans.

Ms. Lissakers also commented that the staff may be premature in declaring the U.S. economy to be at potential. The staff judgment is that the nonaccelerating inflation rate of unemployment (NAIRU) is about 6 percent in terms of the aggregate unemployment rate on the old survey basis. This is well within the range of 5 1/2 to 6 1/4 percent that most other private and public sector estimates fall within, but is somewhat higher than the estimate suggested by Ms. Lissakers. The actual unemployment rate was 6.5 percent in February on the new survey basis; this might be about 6-6 1/4 percent on the old basis, which is close to the staff's estimate of the NAIRU.

Regarding potential growth and the output gap, the staff estimates that actual output will be about 0.1 percent above potential for 1994 on an annual basis, and 0.2 percent above potential in 1995. Ms. Lissakers suggests that the economy will not reach potential until mid-1995, indicating that the difference between the staff and the Administration's assessment of the level of potential output is only about 0.2 percent, which is well within any reasonable confidence interval. The staff assumes a rate of growth of potential output of 2.4 percent, which is the same as reported in the recent Economic Report of the President.

There is, of course, an inevitable degree of uncertainty about any estimate of potential output or the NAIRU. This uncertainty is reflected in the staff's estimates of structural budget balances, to which Mr. Fukui referred. The staff has done sensitivity analyses on the structural budget balance estimates, and it is clear that they are more sensitive to the assumed output gaps than to the assumed lags and elasticities. However, the staff's estimates of the output gap and the NAIRU for Japan are similar to other available estimates. It is worth noting that the change in the gap from 1994 to 1995 is relatively small, and hence the swing to surplus in the estimated structural balance for Japan in 1995 is almost wholly accounted for by the change in the actual balance.

I should also clarify that the staff has not changed the method of calculating the structural budget balances, as stated by Mr. Kiekens. We first presented estimates of structural budget balances in the Board documents discussed last September because we considered them to be a more useful tool to assess medium-term developments in fiscal policies compared with the fiscal impulse measures, which are still reported in the Statistical Appendix.

Mr. Fukui asked about the staff's assessment of the fiscal impact of health care reform in the United States. The staff circulated to the Board a note on recent fiscal developments in the United States on February 14, 1994 (EBD/94/21, Supplement 2) that contained detailed Administration estimates of the fiscal effects of health care reform. At this stage, there are many details about the health care reform package yet to be specified, and hence it is too early for the staff to assess its fiscal implications. I am sure that this issue will be addressed in upcoming Article IV consultations.

Mr. Kagalovsky commented on the paucity of data for the countries in transition in the Statistical Appendix. Except for real growth and inflation, data are not reported for individual developing or transition countries in the Statistical Appendix; and for these two variables, which are reported in Tables A9 and A15, country-specific data for most of the countries in transition are only available for the most recent years. In general, data for the countries in transition are presented in each of the summary tables at the beginning of each section of the Statistical Appendix. As more reliable data become available, we will discuss with our colleagues in the relevant area departments whether there are analytical groupings that could be usefully presented in the Statistical Appendix. The relatively small number of countries in transition, and Russia's large weight, however, may make it difficult to define groups that are not dominated by one or two countries.

Concerning Mr. Wei's question about the estimates of purchasing power parities used in the Statistical Appendix, the staff had consulted closely with its colleagues in the World Bank before adopting purchasing power parity-based weights, and this collaboration has intensified in the last year. The Bank, of course, has been a major supporter of the International Comparisons Project over the years, in part because of the high cost of doing the full-fledged benchmark exercises. However, the country coverage of the International Comparisons Project continues to be limited. In view of the increased interest in purchasing power parity estimates, the Fund and other major multilateral financial organizations have joined with the Bank--with the Bank continuing to play the lead role--to support the development and implementation of a less costly, limited commodity approach to estimating purchasing power parities for most of the nonbenchmark countries.

It will be some time before new purchasing power parity estimates for the developing and transition countries are available. In the meantime, the purchasing power parity-based weights used in the Statistical Appendix for these countries have been updated from 1991-99 to be consistent with the projections in the current World Economic Outlook. The weights reported in Tables A and B of the Statistical Appendix refer to 1990, and these are unchanged from those reported last year. We are in the process of incorporating new historical estimates for the OECD countries, which are estimated by the OECD and EUROSTAT and are published on an annual basis. These new estimates indicate a marginally heavier weight for the industrial countries as a group.

The Economic Counsellor and Director of the Research Department stated that there appeared to have been widespread agreement among Directors, at least on a qualitative basis, on virtually all of the major issues covered in the World Economic Outlook. The sole exception was the assessment of Japanese monetary policy, where, while there had been universal agreement that the monetary easing that had occurred in Japan so far had been appropriate and useful, there remained differences of view as to the advisability of further easing.

There had been broad general agreement on European monetary policy, the Economic Counsellor continued. German short-term interest rates had fallen by 400 basis points since September 1992, and the Bundesbank had clearly indicated that it intended to continue with its policy of gradual, prudent reductions in interest rates. No Director had suggested that the reductions that had occurred so far were inadvisable and, indeed, the general assessment was that they had been helpful. No Director had suggested that further reductions would be undesirable. The only area of disagreement might be whether or not the reductions should have been made, or should be made, at a faster pace, but that disagreement had not clouded the very broad consensus on the general issue of monetary policy in Germany and in Europe. There had been a wide range of other issues in which the differences were not about the qualitative direction of movement, but about the pace of movement.

Most Directors supported the staff's forecast, although some had believed that it should have been a bit more optimistic for one or two countries, or for the industrial countries overall, the Economic Counsellor recalled. Yet other Directors had suggested that the forecast might already be on the optimistic side.

He agreed with Mr. Evans's remarks concerning how to assess the reasonableness of a forecast, and employing Mr. Evans's precepts, he remained reasonably comfortable with the staff's growth forecast of about 2.5 percent for the United Kingdom, the Economic Counsellor stated. Substantial revenue increases were taking effect at the current juncture, the impact of which on consumer spending was not yet known. To some extent, the U.K. recovery would be contingent on the strength of the recovery in the rest of Western Europe. The recent upturn in longer-term interest rates in the United Kingdom was another factor on the downside. On the upside, however, the European recovery could prove to be more vigorous than expected. A similar analysis for most other countries suggested that there was a balance of risks--no lack of potential on the upside, but no lack of risk on the downside.

It had been mentioned by Mr. Hon that the prospects for U.S. inflation might be a bit more worrying, the Economic Counsellor went on. The staff had in fact increased its forecast of U.S. inflation. What would happen on the inflation front beyond the current year was critically dependent on what the policy reactions would be both at the present juncture and in the future. The inflation outturn for 1994 was probably fixed already, and not much could be done about it from a policy perspective, but the inflation rate for 1995 and beyond would be influenced by the near-term policy decisions.

It was important to emphasize that, while the forecasts were more optimistic than they had been for some time, they were still not envisaging buoyant growth in many of the industrial countries, the Economic Counsellor stressed. Margins of slack remained very wide in most industrial countries--indeed, in essentially all the industrial countries except the United States. Unemployment rates were very high, and were probably still rising in Europe. The projected pace of expansion in Europe in 1994 was not sufficiently rapid to prevent a further increase in unemployment. Indeed, even in 1995, the projected pace of expansion was not sufficient to bring about substantial reductions in unemployment. Thus, while the economic prospects had improved, there were no grounds for complacency.

With respect to Mr. Smee's first in, first out theory of business cycles, the Economic Counsellor commented, he agreed that economic recovery was not always automatic or independent of policy actions to help promote recovery. However, it was important to recognize that the business cycle had its own internal dynamic, and that it tended to be true that economies that entered a recession first emerged from it first. While policy clearly played an important role, it should not be assumed that policy alone drove the cycle.

A few Directors had said that the sentence "current account imbalances are not necessarily undesirable" could be phrased somewhat differently, the Economic Counsellor noted. Certainly, current account surpluses and deficits could be referred to in that context, rather than imbalances. From a policy perspective, as many Directors had emphasized, there was an important cyclical element in the present level of current account surpluses and deficits. With the United States recovering earlier and relatively vigorously, and other countries still in recession, there had been a cyclical tendency for the current account deficit of the United States to rise while others had been moving in the opposite direction. The reversal of that cyclical element could be anticipated, but that did not imply that policy actions had no role in helping to produce such a reversal of those imbalances. At the same time, there was also a substantial longer-term structural imbalance between some countries, in particular on an aggregate basis, related to their longer-term savings and investment position. The persistence of moderate imbalances--or surpluses and deficits--associated with those longer-term differences between savings and investment was not necessarily undesirable; it was an essential function of the international monetary and financial system to permit resources to flow between countries.

There had been little disagreement on the issue of inflation targets for monetary policy, the Economic Counsellor stated. Clearly, some countries with long-established records of price stability, or near-stability, without explicit inflation targets felt no need to adopt them. Other countries adopted an exchange rate anchor to a country that maintained reasonable price stability as a way of establishing the credibility of the medium-term objective. Some Directors had commented that, for countries that were not in those situations, the announcement of an explicit inflation target could be useful in providing a clear signal of the authorities' policy intentions and objectives. As Mr. Lanciotti had emphasized, it was particularly important that, while the inflation target should serve to guide the central bank in what it should do, it should not be the objective only of the central bank, but of the government, and it needed to be supported by the population at large. In fact, in those countries with an inflation target, that appeared to be the case. In Canada, New Zealand, the United Kingdom, and Sweden, for example, there was an agreement between the finance ministry and the central bank along those lines. Several Directors had also emphasized that having an inflation target was not nearly as important as delivering a predictably and sustainably low rate of inflation, which was not always easy. In that connection, as the American writer Mark Twain had put it, it was hard to build a reputation on what you were going to do.

There had been a fairly extensive discussion of the policies of developing countries, policies that contributed to growth and policies that had been responsible for the less satisfactory performance of some developing countries, the Economic Counsellor observed. A number of questions had been asked about the role and effectiveness of Fund programs in that regard. Those issues and questions could be dealt with in more depth during the review of conditionality that was expected to take place in the summer. In many developing countries, and among the poorest, in particular, where the agricultural sector bulked very large and where distortions in that sector were often extreme, the reform of agricultural policies was clearly a critical issue. The World Bank had devoted considerable attention to those questions. Reform of the financial sector, both in developing countries and in the economies in transition, was another critical area, and there, the Fund, as well as the Bank, was deeply concerned.

The staff had a continuing interest in the subject of capital inflows and capital controls, and work continued on those issues, the Economic Counsellor related. There would undoubtedly be opportunities for further discussion in the future.

Several Directors had emphasized the importance of good governance, which had been highlighted in the World Economic Outlook, and Mr. Hon and others had also emphasized the importance of political stability and political consensus behind the government's economic policy strategy, the Economic Counsellor recalled. It was certainly the case that, historically, where there was not political stability, growth and development proved difficult. Thucydides, in his discourse on the Peloponnesian War, had commented on that subject in an earlier era.

There had been a number of useful comments from Directors on the policies and conditions for successful transformation of economies in transition, the Economic Counsellor considered. Mr. Kaeser had mentioned in particular the interesting fact that the countries that had been most successful in undertaking and implementing reforms had spent the least amount of time under the system of central planning. At the same time, it was important to recognize that there had been considerable variations in the experience of Eastern European countries--contrasting Bulgaria and Romania, on the one hand, and Poland and the Czech Republic, on the other, for example. Part of the explanation for that difference probably lay in the level of development before the era of central planning, but he also believed that certain of the less successful economies had been inherently more vulnerable to the collapse of the Council of Mutual Economic Assistance (CMEA) than those that had been more successful initially.

The staff had substantially underestimated the fall of output that would be occasioned on the collapse of the CMEA, and in particular of the former Soviet Union, as Mr. Kagalovsky had pointed out, the Economic Counsellor acknowledged. However, he recalled a conversation he had had with Mrs. Schaumayer, the Governor of the Austrian National Bank, during the 1991 Annual Meeting in Bangkok, Thailand, when he had characterized the collapse of the Soviet Union as entailing "economic Chernobyl," with industrial output falling by 50 percent before the situation would stabilize. He believed that the decline in production had come to nearly that, on average, in the republics of the former Soviet Union. It should have been anticipated that, once the system that controlled the allocation of resources across a broad area was eliminated, the problems of adjustment would be enormous. It was important to recognize that there would probably have been no set of policies that could have avoided a major downturn in industrial activity in those countries. However, perhaps it would have been helpful if that problem had been anticipated more broadly and at an earlier stage in light of the political difficulties in sustaining the reform effort that had been seen. In many countries at present, the collapse of activity was being blamed not on the previous system, but rather on the reform efforts, which was really not the right diagnosis of the source of the difficulty.

Also, Mr. Kagalovsky had commented on the difficulty of securing private financing of investment in the reforming economies, the Economic Counsellor continued. There was a problem both in terms of internal financing of investment, but also--and especially--of external financing of investment. A key part of the difficulty was that investors looked for a secure return on their investment. When there were doubts on that score, it was difficult to secure private investment flows; private investors found it difficult to persuade themselves to take on the risk associated with whether or not the transformation would be made successfully. That was why official financing needed to play a particularly critical role at the early stages of economic transformation.

In that regard, it was important to emphasize that the situation in Eastern Europe and the countries of the former Soviet Union might be substantially different from the situation in many of the poorer developing countries, because of the large stock of able human capital and other important resources in the former, the Economic Counsellor went on. In the short term, the problem was that the system of organizing the resources effectively to produce the desired consumer or investment goods and services either had not yet been set in place, or was not functioning efficiently. If it could be set in place relatively rapidly, then the prospects were good for a relatively rapid upturn of economic activity over a period of ten years or so.

The staff would make appropriate modifications to the table on financial assistance to Russia, in particular concerning the much discussed--but not discussed officially with the Russian authorities--stabilization fund, the Economic Counsellor confirmed. While the stabilization fund had been discussed among the industrial countries, it had never been established or activated, because one of the conditions for activating it--that there be reasonable prospects for stabilizing the nominal exchange rate of the ruble--had not been met, taking into account the financial policies in Russia. The table would try to make that distinction clearer.

There had been a difference of views among Directors on the issue of monetary policy in Japan, the Economic Counsellor recalled. He could agree with Mr. Kiekens and several others who had suggested that the World Economic Outlook had probably not placed enough emphasis on structural reform in Japan, and Mr. Fukui had mentioned that point as well. The staff report for the 1994 Article IV consultation with Japan would take up that issue, as it had in years past. Nevertheless, the staff would strengthen somewhat the language in Chapter 1 to put more emphasis on the importance of structural reform in Japan.

With respect to Japanese fiscal policy, Table 46 had attracted the attention of Mr. Evans and Ms. Lissakers, and a response by Mr. Fukui, the Economic Counsellor continued. Mr. Wei had requested staff views on the room for maneuver of fiscal policy. Mr. Fukui had questioned the staff estimates of the size of the multiplier and the output gap. Mr. Posthumus and several others had commented on the desirability of avoiding excessive use of fiscal policy in an effort to fine-tune the economy. In any case, there appeared to be broad agreement among Directors that the Japanese authorities had been correct to use fiscal policy to support the economy in the face of very strong forces that were tending to depress the level of activity, and given the large and growing margin of slack in the economy. The Japanese Government had taken significant fiscal measures to contain the downturn in activity--even if some would perhaps have wanted stronger and earlier measures--which had been effective in the face of very large negative impulses to the Japanese economy; there was direct evidence of that from the sectors that had been most prominently affected: public investment and private construction. To put that in perspective, much had been said about the 400 point decline in the Dow Jones industrial average from its peak of 3,900 early in 1994; in contrast, the Nikkei index had dropped from 39,000 to below 15,000--equivalent to a decline in the Dow Jones from 3,900 to 1500, a decline that would cause a recession of truly unpleasant proportions in the United States. In Japan, there had been an enormous drop in real estate values, a big falloff in investment after a big investment boom, the problem of the appreciation of the yen, and difficulties in the financial sector. The Japanese economy had weathered that storm, with growth falling from 1 percent in 1992 to zero in 1993, and to a little below 1 percent in 1994. The monetary and fiscal policy actions had helped to contain what otherwise could have been an even more dramatic downturn.

That being said, there was a wide margin of slack in the Japanese economy at the current juncture, and that margin of slack was not expected to narrow much, if at all, during the current year, or even very much in the following year, the Economic Counsellor went on. Estimates of the margin of slack could differ, especially in light of what had been happening to investment in Japan, but in terms of policy analysis and prescription at the present stage, how big the margin of slack was did not really matter. It was quite big, and it was not going to be closed over the period of the next two, or three, or even four years.

Similarly, with respect to the issue of the fiscal multipliers, the key constraint was the magnitude of Japanese fiscal policy intervention, the Economic Counsellor proposed. Whether the public investment multiplier was 1.0 or 1.2 did not make much difference, taking into account the magnitude of the problems that the fiscal policy needed to address, including the wide margin of slack. The staff's advice had been to use fiscal policy to assist the start of the recovery in Japan and to assure that the recovery proceeded into the sustainable phase of expansion, and then to gradually withdraw fiscal support in accordance with the necessary medium-term objective of reconsolidating the Japanese fiscal position. The staff had never suggested attempting to use fiscal policy to drive activity all the way back to potential; at some point, as the gap stopped widening and began to narrow, fiscal stimulus should be gradually withdrawn.

The staff had believed that it had been wise to rely heavily on increases in public investment spending in Japan, because public investment spending was much easier to reverse than other forms of fiscal stimulus, the Economic Counsellor explained. There was a natural tendency for the level of spending to decline as projects were completed. Also, public investment spending that would have occurred somewhat later otherwise was being pushed forward, so to some extent, spending was increasing at present at the expense of spending that would have taken place later. The structural budget deficit was projected to decline by 1 1/2 percentage points of GDP between 1994 and 1995 because of the completion of projects and the fact that the tax cut had been approved for only one year. Thus, fiscal support was projected to decline in 1995. While the staff did not believe that fiscal support would actually be withdrawn to that extent, it needed to be borne in mind that the staff's projections were based on established policies. As Mr. Fukui had pointed out, the Japanese Government had indicated its intention to continue with at least a second year of the tax cut, and later, there would need to be an offset to that in terms of other sources of revenue. The practice in the past had been for there to be supplemental budgets in the fall of the year, or for the regular budget to include a substantial additional dose of public investment spending, as had happened in the current year. The staff believed that one or the other of those actions, or perhaps both, would be needed in 1994 or 1995 to keep public investment spending in Japan at least at the level that was currently projected. There was probably additional room for maneuver, as Mr. Wei had intimated, but there were limits on how much, and how rapidly, public investment spending could be increased. Similarly, on the tax cut side, perhaps the tax cut could have been a bit larger, or perhaps it could be larger in 1995, but again, there were limits.

The staff was recommending neither a tightening nor an easing of monetary policy in Canada, the Economic Counsellor stated. In the recent past few weeks and days, markets seemed to be questioning the credibility of Canadian fiscal and monetary policy. The Canadian dollar had been under sharp downward pressure; long-term interest rates had been pushed up by market forces; and it had been necessary for the Bank of Canada both to intervene in the foreign exchange market and to raise significantly short-term interest rates. The appropriate policy response to that was a clearer signal from the Government of its intention to proceed more vigorously on the fiscal front, which would help to reassure financial markets.

With respect to the question whether Canadian monetary policy had been too tight for too long, thereby producing an unnecessarily deep and prolonged recession and worsening the problem of the fiscal balance, it needed to be borne in mind that in the late 1980s, the Canadian economy had clearly overheated, the Economic Counsellor commented. That overheating had been facilitated partly by the delay in tightening Canadian monetary policy, as the Bank of Canada had moved later than had the U.S. Federal Reserve after the stock market crash of 1987. With the buildup of inflationary pressures in both prices and wages and the clear evidence that output had risen above potential, Canada could not hope to escape from that overheating episode without at least a moderately deep and prolonged recession. That was the cost of not acting soon enough and vigorously enough to contain the increase in inflationary pressures as they began to take hold. From that perspective, monetary policy had not been too tight, although perhaps it could have been eased somewhat more rapidly during the course of 1991. In making a judgment on that issue, it was important to bear in mind the difficulty of monetary policymaking and the need to distinguish between hindsight and real time decision making. Monetary policy decision making was much like driving a car through a fog; one was not exactly sure where one was, or exactly where one was headed. In those circumstances, difficult decisions had to be made about how to operate the levers of monetary policy. In the clear light of hindsight, of course, the Canadian inflation rate had fallen more rapidly than was programmed, and it could probably be said that policy had been too tight for too long. It was questionable whether such an assessment would have been made at that time, however. As an aside in that connection, insisting that persuasive evidence of the correctness of a particular policy was the fact that it was right in the light of hindsight ignored the fact that a key element in policy decisions was the environment of uncertainty in which they were made, in his view, and mistakes perceived only in the light of hindsight should be the order of the day. Those mistakes could go in both directions: remaining too easy when tightening was needed, and being too tight when an easing might have been helpful.

The relevant question in Canada was what should be done at the current juncture, given that the inflation rate in Canada had been brought down to a very low level, the Economic Counsellor observed. In that connection, the problem of the right advice might be illustrated by the problem that his predecessor as Economic Counsellor, Mr. Jacob Frenkel, had described as facing a motorist who had just run over a pedestrian; the best course of action under such circumstances was not necessarily to do the opposite of what had caused the problem in the first place--that is, to reverse the car, thereby running over the pedestrian again. In the case of Canada, which had paid a substantial price to bring the inflation rate down, it was not appropriate to reverse direction and allow the inflation rate to rise. The fear that such a policy would indeed be implemented might be behind some of the market's recent reactions.

Economic policy in the United States faced some challenging choices, the Economic Counsellor considered, especially in the area of monetary policy. Both monetary and fiscal policy had been effective in achieving important progress in their key goals. The recession in the United States had been very mild, the mildest of the post-war period. The inflation rate had been running for the three preceding years, and would continue to run in the current year, at the lowest consistent level in 25 years. The unemployment rate, on the old measure, was 1/2 of 1 percentage point below the average of the past 25 years. Monetary policy had helped to bring the level of activity back to, or very near, potential. The United States was the only major industrial country in that relatively happy situation. The ratio of the visible public debt to GDP had approximately stabilized on a structural basis, although that ratio remained at a high level on a historical basis. Maintaining that position would be contingent on containing the future growth of entitlement spending.

Directors had broadly agreed that the prescription for U.S. fiscal policy included the need for some further tightening in 1995 and beyond, the Economic Counsellor recalled. It was wiser to take action to reduce fiscal deficits during an expansion than during a recession. In that context, while the fiscal position of the United States needed improvement, it was not such that fiscal tightening during a recession would be useful, and for that reason, he would not advocate further fiscal tightening in the United States in 1995 if there was good evidence that the United States was headed into recession. Bringing the deficit down and putting the U.S. economy on a path of gradually declining debt ratios was fully consistent with the medium-term strategy. Adherence to the medium-term strategy implied that the medium-term objective should exert an important influence on how policy was actually conducted. For countries like Italy and Sweden, with large fiscal deficits and public confidence eroded, cutting the deficit, even in a recession, was important and valuable even in the very short term. For the United States, it had been appropriate to make a major fiscal effort as the economy moved into expansion, and to resist an easing of fiscal policy--as evidenced by the failure of Congress to pass the fiscal stimulus package--during the recession. The U.S. economy in 1993 had not been at a stage where a little additional fiscal stimulus would have been needed or desirable. The authorities should avail themselves of the economic expansion by bringing about further reductions in the deficit, so that when the recession came, there would not be the need to contract fiscal policy. If the fiscal position was relatively strong, and if, as in Japan, there were enormous forces pushing the economy down, then the use of fiscal policy for stimulative purposes could even be contemplated. Such an approach to policy would deliver a sustainable fiscal position over the medium term, without having fiscal policy contribute to the magnitude of cyclical fluctuations.

The U.S. economy, by any reasonable measure, was at present nearer to potential, and appeared to have considerable forward momentum, the Economic Counsellor observed. As activity in other industrial countries began to pick up later in 1994 and into 1995, U.S. exports should strengthen somewhat, and the deterioration of U.S. net exports should probably ease somewhat. If U.S. domestic demand continued to expand at somewhat more than a 4 percent rate--the rate at which it had expanded since the beginning of 1992--the question arose as to where the capacity would come from to meet the increasing demand for U.S. exports, and what would happen to U.S.

inflation and inflation expectations as world commodity prices began to rise in the context of a general recovery in the industrial countries. He believed that, looking ahead a year or so, the risk was greater that the economy would grow above the level of potential, than that it would face a sinking in activity relative to potential. The right monetary policy was not one that drove the economy so fast that the brakes had then to be applied forcefully, thus running the risk of an upsurge of inflation and a sharp tightening of monetary policy that could cause another recession late in 1995 or by early 1996. Rather, the long-run average level of activity would be higher and the long-run average unemployment rate would be lower if growth was slowed as the economy approached potential. The average unemployment rate over the preceding 25 years had been above the level associated with potential primarily because the economy had had some large deep recessions from which it had taken a long time to recover. The average performance of unemployment could be improved by avoiding such sharp, prolonged cyclical downturns.

Even if the U.S. authorities' growth forecast and assessment of potential was right, the sensible and prudent monetary policy was to move at the current juncture to a significantly less accommodative stance, before the economy exceeded its potential, the Economic Counsellor emphasized. That did not mean an expansion-crushing tightening that would flatten out the yield curve by pushing the federal funds rate to 8 percent, but rather, enough of a tightening to have a meaningful, credible slowing effect on the expansion, and which the market could expect would be followed by further steps. The recent actions of the U.S. Federal Reserve should be seen in that light, rather than as a cause of the awakening of inflationary expectations that might have lain dormant otherwise. In his view, maintaining an easy monetary policy until the economy was driven up to a relatively optimistic view of potential was not fine-tuning, it was poor tuning.

A number of Directors had commented on the implications of U.S. monetary policy for Europe, the Economic Counsellor stated. Mr. Lanciotti had noted a dilemma of policy divergence, Mr. Ahmed and others had called for more active policy coordination, and Mr. Zoccali had noted the constraints that U.S. monetary policy appeared to be placing on Europe. Of course, with hindsight, it would have been preferable to achieve an effective tightening of U.S. monetary policy through a 100 basis point increase in short-term rates and a 50 basis point increase in long-term rates, rather than a 50 basis point increase in short-term rates and a 100 basis point increase in long-term rates. The increase in long-term rates would help to slow the economy, but there was evidence that movements in long-term rates tended to be transmitted more easily across economies than movements in short-term rates. Therefore, a plausible case could be made that more aggressive action in moving short-term rates in the United States might have been beneficial; when the market believed that more action was required on short-term rates, it tended to push up long-term rates. The experience of the early 1990s showed that, while long-term rates among the major industrial countries tended to move together, there was a major divergence in the movements in short-term rates. The United States had been able to push down U.S. short-term rates at the same time that the Bundesbank was pushing up German short-term rates. The federal funds rate had moved from 10 percent in early 1989 to 3 percent, and the Bundesbank's rate had moved from 6 percent to 10 percent over the same period. Such a dramatic realignment of interest rates was clearly unwarranted at the present juncture, but more action on the short end of the market was probably desirable, where the linkage between Europe and the United States was weaker.

Ms. Lissakers commented that the impact on long-term interest rates of the change in the composition of banks' portfolios and the rising demand for bank credit--both of which were a sign of healthy growth and investment--needed to be taken into account. The banks had financed an increased level of commercial and industrial lending in part by shedding their very large accumulations of government paper. That action was independent of inflation expectations per se, but could have the effect of driving up government bond yields.

The Economic Counsellor and Director of the Research Department responded that increasing private sector credit demand had been an important reason for the increase, both in nominal and in real terms, of long-term interest rates, but inflation expectations accounted for a bit of it as well. Some meaningful increase in longer-term rates in the United States seemed desirable as the U.S. economy recovered, although it would have been better to have had more action on short-term rates at an earlier stage, and not so much on long-term rates. Tightened monetary policy to slow economic growth to a rate closer to the economy's potential implied higher long- or short-term rates, greater constraints on the amount of credit, a drop in stock market values, or a combination of those events. It would probably be better for the U.S. economy if growth from the end of the last quarter of 1994 was at a 2 percent rate rather than a 4 percent rate, because there would be less risk of overheating and, ultimately, a commensurate extreme tightening by the Federal Reserve.

Mr. Fukui observed that the U.S. savings ratio had fallen again, by about 1 percent, to an all-time low level of 4.3 percent. Household debt was also at an all-time high. The level of savings and debt had obvious implications for U.S. monetary policy. In the past, the savings and debt levels had had a positive effect, as declining interest rates had encouraged increased private consumption. The other side of the coin, of course, was that the high debt levels would tend to depress consumption as interest rates rose. He hoped that the Federal Reserve would take that situation into account in its formulation of appropriate monetary policy in the United States.

The Economic Counsellor and Director of the Research Department replied that if the economy was near potential and was growing rapidly, a tightening of monetary policy was needed to begin to slow expenditure and discourage consumer borrowing and spending. Ideally, monetary policy should operate across a broad front, rather than only on certain sectors such as housing and construction, for example. How much monetary policy tightening would be needed to achieve a particular slowdown in demand growth was sensitive to the extent to which consumer spending was likely to be affected by an increase in interest rates. In that connection, it might be noted that the link between the federal funds rate and interest rates charged to consumers on credit cards and other consumer credit was not very close.

While the savings rate in the United States was low, it needed to be borne in mind that U.S. consumers had been changing the form of their savings recently, the Economic Counsellor pointed out. In particular, they had been buying automobiles and other consumer durables, which, from an economic perspective, should be thought of as an asset accumulation or the transformation of an asset from one form to another, rather than as the spending of accrued wealth on current consumption. Moreover, while the debt ratio in the United States was relatively high, the level of assets was also relatively high, and net consumer wealth relative to GDP was quite large. Finally, the cost of transactions in the financial sector had been reduced significantly as a consequence of the information revolution, and many households were both substantial net debtors and substantial net creditors, accordingly. For example, a household's money market mutual fund could hold the receivables from the household's credit card balance that had been issued by the credit card company. Thus, the increase in gross consumer debt substantially exaggerated what had been happening to the net financial position of households. That notwithstanding, the low saving rate remained an issue of considerable concern.

Ms. Langdon stated that the process of reassuring markets of the policymakers' commitment to price stability and fiscal consolidation had already begun in Canada. The Governor of the Bank of Canada had likened inflation control to steering a car; just because one was pleased with one's progress and the direction in which one was headed did not mean that one could stop steering and divert one's attention elsewhere.

The Economic Counsellor and Director of the Research Department said that there had been universal agreement on the need for vigorous action on the fiscal front across Europe, and especially in those countries with large deficits and high public debt ratios, such as, inter alia, Italy, Spain, Sweden, Turkey, Greece, Belgium, and Finland. New Zealand and Australia seemed to be recovering well, and maintaining low inflation rates. Switzerland's economy seemed to be improving, along with some of the other smaller countries in Europe. Directors had been generally optimistic that relatively rapid growth would continue in the developing countries, at least as a group.

While evidence from the performance of index-linked bonds seemed to suggest a significant increase in longer-term inflationary expectations in the United Kingdom, the Economic Counsellor remarked, it needed to be interpreted with a degree of caution, in view of the apparently adverse market reaction to the most recent easing of monetary policy. The staff believed that caution should be exercised in any further monetary easing, unless there was good evidence that inflation and inflationary expectations were improving. Directors appeared to agree with the comments he had made about U.K. fiscal policy in his opening remarks.

There were a number of positive aspects to note in the French economy, including the low level of long-term interest rates, the consistently low level of inflation, the fact that the exchange rate had returned to within the band, the modest but positive growth recorded in recent quarters, and the prospect of continuing recovery in 1994 and beyond, the Economic Counsellor continued. Mr. Autheman had said that the French economy had improved in spite of the authorities' disregarding the Fund's advice. At the same time, however, the unemployment rate in France was 12 percent and might well still be rising, and it was not expected to fall much in 1995. The cumulative output loss of actual relative to potential GDP during the current cycle in France, through 1995, amounted to 14 percentage points of GDP. If growth were to run 1 percent above potential each year thereafter, the cumulative loss would exceed 20 percentage points of GDP before potential was regained. Therefore, the cyclical episode had involved a substantial output loss. Also, the budget deficit, which had been reduced to very low levels at the end of the 1980s, had been driven off course, largely as a consequence of cyclical developments, but also because of some structural deterioration. Given events elsewhere in the world economy and the normal cyclical progression of an economy, France would not have avoided some meaningful cyclical downturn in the early 1990s, but it was important to recognize that the situation had not been the same for France as for Germany. In France, there had not been overheating to the extent that had occurred in the German economy, and there was not the massive shift in fiscal policy that had occurred in conjunction with German unification. The question needed to be raised of what would have happened if policy had been different. In his view, the loss of output relative to potential had been twice as great, and would last twice as long, as would have occurred had an alternative policy been adopted in the summer of 1991 that, while still delivering consistently low inflation, would not have placed the same emphasis on sustaining the exchange rate, or that would have allowed for a revaluation or a floating of the deutsche mark and the guilder vis-à-vis the franc.

Of course, with the negotiations for the Maastricht Treaty and for other reasons, moving off the peg in the summer of 1991 would have been politically difficult, and would have had substantial longer-term costs in that dimension, the Economic Counsellor acknowledged. While much of the output loss from the current cyclical episode derived from what had happened after the summer of 1992--as French interest rates had not only kept up with German interest rates, but had actually been forced to offer substantial premiums above German interest rates--the output loss of 10-12 percentage points of GDP was probably the consequence of the policy choice that had been made then. If a more flexible policy had been adopted after August 1993, when the ERM bands were widened, an earlier and more vigorous onset of the recovery would have occurred--probably by 1995, 1996, or 1997--with a benefit of 3-4 percentage points of GDP.

The commitment to economic and monetary union (EMU) was important both politically and economically, the Economic Counsellor observed. That commitment would have been difficult to maintain had the exchange rates been loosened in the summer of 1991, but that commitment would have been less damaged if they had been loosened in the summer of 1993. In any case, it was clear that a substantial cost had been paid, and was being paid, for the policy choices that had been made. It was neither obvious nor absurd to suggest that the benefits might not entirely outweigh the costs.

Mr. Autheman commented that he did not challenge the view that a different policy would have had a different outcome, in particular with respect to the external position, long-term interest rates, and the rate of inflation. However, the Economic Counsellor was making a different political judgment than the one that France had had to make.

The Economic Counsellor and Director of the Research Department said that with regard to Germany, as for other countries, there had been broad agreement on the importance and appropriateness of fiscal action, and recognition of the substantial fiscal action that the German authorities had taken. Perhaps if the authorities had moved more vigorously in 1992, the fiscal policy contraction at that stage could have supported monetary policy, whereas at present the contraction was perhaps a bit less helpful from a cyclical standpoint. He broadly agreed with the qualitative features of the Bundesbank's monetary policy. Mr. Schoenberg had invited onlookers to examine the results of German monetary policy, which had been effective over a period of many years in delivering a relatively low and stable inflation rate. While one could question whether or not the recent easing should have been a bit more rapid, the general thrust of the Bundesbank's policy seemed to have been appropriate, in view of the problem of the substantial increase in inflationary pressures.

German monetary policy has been characterized by Mr. Schoenberg as stability oriented, governed primarily by medium-term objectives, and guided importantly by the behavior of monetary aggregates, in particular M3, the Economic Counsellor recalled. It was not as concerned with supporting output or with efforts at Keynesian fine-tuning.

There had clearly been overheating in the German economy in 1990 and 1991, the Economic Counsellor continued. Large wage increases had been pushing the inflation rate up, and it would have gone up even further if the Bundesbank had not taken vigorous action by tightening monetary policy in 1991 and keeping it tight in 1992. However, looking at the key indicators of German monetary policy, the targeted aggregate, M3, had continued to grow very rapidly through 1991 and 1992, and indeed it continued to grow quite rapidly at present. That implied that monetary policy in fact had been very loose, indeed irresponsibly loose, as measured by not only the growth rate, but also the growth rate relative to the target. The Bundesbank had explained that a variety of special factors had pushed M3 off course, but over the long term, the behavior of M3 did not suggest the tightening that the Bundesbank obviously and rightly had carried out. Short-term interest rates in both nominal and real terms--relative to long-term rates--and the slope of the yield curve suggested the tightening of monetary policy in 1991, and the holding tight through 1992. The subsequent performance both of the economy and of the inflation rate demonstrated that monetary policy had in fact been tight.

It was difficult to argue that German monetary policy was concerned exclusively with medium-term price stability and ignored the implications for the behavior of output, the Economic Counsellor considered. If short-term interest rates in Germany had been pushed to 15-20 percent at the end of 1991 and the first half of 1992, even more rapid progress would have been made in reducing the inflation rate, probably to 2 percent over the preceding 12 months. That was not done because the Bundesbank, like every other responsible central bank, believed that the level of activity and the behavior of the economy did matter, and should be taken into account in setting policy. There had been the clear desire not to create an excessively deep and prolonged recession, even if the necessary tightening of monetary policy would produce a significant recession.

Beginning in September 1992, monetary policy in Germany had begun to ease as measured by the securities repurchase rate, but only gradually, the Economic Counsellor went on. Interest rates were still at 9 percent at the end of 1992, and were reduced only gradually thereafter. At the current juncture, short-term interest rates had fallen by 400 basis points, and monetary policy might be characterized as not tight, and perhaps even as easy.

The idea that the Bundesbank had been targeting M3 behavior was not a plausible explanation, therefore, the Economic Counsellor proposed. If the Bundesbank had been attempting to keep M3 within its proclaimed targets, an easing of interest rates would not have occurred. In his view, therefore, the behavior of M3 was not a guide to German monetary policymaking. Moreover, in the current period of an easing of German monetary policy, it was not plausible to argue that only the medium-term objective of price stability was influencing interest rate policy. If short-term interest rates had been kept at 10 percent from September 1992 to September 1993, a more rapid disinflation would have occurred, but a deeper and longer recession would also have occurred.

The Bundesbank's performance demonstrated that it was best not to allow inflationary pressures to build up in the first place, but that once they did, it became important to take early and aggressive action to deal with those pressures, the Economic Counsellor and Director of the Research Department concluded. It was also important not to let concern about the behavior of short-term output forestall action that was needed to pursue the medium-term objective of reasonable price stability. At the same time, that was not to say that the behavior of output was not a legitimate and, indeed, important concern in the management of monetary policy; that was true for Germany as well as for other countries.

Mr. Fukui stated that he was very interested in the phenomenal growth performance of the East Asian countries and the role of intraregional trade. Both were expanding at a rapid pace in spite of the relatively slow economic growth of the industrial countries. It appeared that those dynamic economies were somehow delinking their terms of trade from the industrial countries, and were becoming increasingly an independent component in their own right in the world economy. He hoped that the coverage of the East Asian economies would be expanded in future World Economic Outlooks. The role of private direct investment in those countries needed to be given more attention, in the context of the globalization of foreign direct investment.

With regard to fiscal policy in Japan, he agreed that it would be necessary for heavy public investment spending to continue, Mr. Fukui went on. Unfortunately, the political scandals of the previous year had had a dampening effect on the implementation of the public investment program, but it was returning to a normal level. The public investment program would be implemented in full in the course of 1994. At the same time, there were limits to what could be done, as the Economic Counsellor had pointed out. The Japanese structural balance, excluding social insurance, was trending toward a substantial deficit. The social security fund was treated as a debt rather than an asset, and in that context, the surplus in the social insurance fund should not be included in assessing the fiscal balance.

Assessing the fiscal situation was quite judgmental, Mr. Fukui observed. One indicator was the ratio of outstanding government long-term debt to GNP, for which the ratio for Japan stood at 53 percent. The Government had set itself a target of stabilizing that ratio by 1995, but it was clear that that would not be met. For the United States, the ratio was 59 percent, but there was a better chance that it could be lowered. The ratio for the United Kingdom was 33 percent; for Germany, 20 percent; and for France, 18 percent. Those figures were in sharp contrast with the figure for Japan, and it appeared that Japan was among the highest ranking members of that government debt "club." Interest payments against government expenditure stood at 15.9 percent in the Japanese case, 14 percent in the United States, 5 percent in the United Kingdom, 11 percent in Germany, and 13 percent in France. Thus, interest payments in Japan were among the largest among the major industrial countries. The overall government deficit was also high, at 18 percent; for the United States, that figure stood at 11 percent; for England, 16 percent; for Germany, 14 percent; and for France, 19 percent. He believed that the fiscal situation in Japan was clearly worsening, and serious thought needed to be given to how to respond to that deterioration. He appreciated the staff's emphasis on the need for medium-term fiscal consolidation in Japan.

The financial condition of the banking system was a key concern in the assessment of the Japanese economy, Mr. Fukui confirmed. It had been reported in the Japanese financial press that the commercial banks were expected to make adjustments for nonperforming loans in their portfolios by the end of March or beginning of April 1994. The major banks had been aggressive in liquidating their nonperforming loans, and as of end-March 1994, about 80 percent of such loans had been liquidated. It was expected that virtually all such loans, including those held by trust banks, would be cleared by March 1995.

He had been pleased to hear the discussion on current account imbalances, which of course were of interest to the Japanese authorities, Mr. Fukui concluded. He agreed that current account surpluses or deficits were not, in themselves, entirely undesirable from the medium-term perspective.

Mr. Schoenberg stated that the Economic Counsellor's characterization of German fiscal and monetary policy had been appropriate and fair. Of course, the actual behavior of M3 did not fully explain actual Bundesbank action over the course of the previous years, which underlined the fact that the Bundesbank was interpreting the movement of its M3 intermediate target in an enlightened way, taking into account other indicators. The Bundesbank was also taking into account the various components of M3. If M3 were broken down into various components, it could be shown that credit to the business sector, for example, had been growing until recently at a very strong rate. That factor had not been distorted in the same fashion as other components by other short-term factors.

He remained concerned that, in the actual formulation of the policy requirements, the staff risked overlooking medium-term necessities, Mr. Schoenberg commented. Even without an explicit discussion of medium-term policy requirements, the staff should implicitly take into account the medium-term strategy in its suggestions for the policy requirements.

He had noted that there were still some charts and tables in the World Economic Outlook that included the concept of West Germany, Mr. Schoenberg concluded. Three-and-a-half years after unification, such a perspective tended to underrate the dynamism of developments in Germany. In particular, growth in eastern Germany in 1994 was projected to reach 7-10 percent. Therefore, the staff should use Germany as a whole in the presentation of some of the statistical material, in particular for the chart on GNP growth in the major industrial countries.

The first staff representative from the Research Department observed that, wherever "West Germany" was referred to, it reflected a constraint on the availability of data, in particular of quarterly data. The staff would undertake to broaden the statistical definition of Germany wherever possible, however.

Mr. Posthumus said that while he agreed that the staff's recommendations to reformulate paragraph 1 of the World Economic Outlook represented a strengthening of the text concerning the importance of the conclusion of the Uruguay Round, more substantial information on that topic was needed in the rest of the presentation as well. The emphasis at present was on the importance of the Uruguay Round for the developing countries; there was nothing about the importance of the Round for the industrial countries or the countries in transition. There was an estimate of an increase of trade and growth in the future in the annex, for all countries together. In his view, the fact was that the Uruguay Round would contribute to a major improvement of the world economic outlook--and the World Economic Outlook did not show it. Thus, he could not agree with the solution that had been proposed by the staff.

The Chairman said that he recalled that the first staff representative from the Research Department had said that the conclusion of the Uruguay Round was particularly significant and would enhance considerably the trading opportunities for both industrial and developing countries.

Mr. Posthumus replied that that point was not illustrated in the rest of the World Economic Outlook. In his view, the results of the Uruguay Round would be seen over a period of 10-15 years. The Round would usher in changes in the mechanisms of international trade all over the world, and not just in developing countries. Similar changes had been witnessed after the freeing of capital markets; some developments had been completely unexpected, and they had presented new challenges for policymaking. The flavor of that was not in the paper.

He would never advise a strengthening of fiscal consolidation measures in a period of economic downturn, or a loosening in a period of upturn, Mr. Posthumus continued. If countries intended to reduce their deficits over a period of years, they should try to do it in a way that also reduced their structural deficits, while allowing the automatic stabilizers to work. That implied a smooth downward trend for the structural deficit, if not for the actual deficit. Stressing that more could be done on the deficit front in good times than in bad times--as the Economic Counsellor had done--was to run the risk of ignoring the need to work down the deficit even in bad times, and indeed, to invite calls for stimulative measures as soon as the economic situation started to deteriorate.

With respect to Table 17, the stabilization fund for Russia was a stock and not a flow, in his view. He did not believe that the Fund should publish a table showing official financial assistance from the Group of Seven industrial countries--those countries could do so on their own.

The Chairman said that the table would be modified to reflect the concerns of Mr. Posthumus and other Directors.

The Economic Counsellor and Director of the Research Department replied that the title of the table would be changed to reflect the reality.

Mr. Fukui said that Japan was considering a major tax reform. He wondered whether the staff could indicate what the impact of such a reform would be on the structural budget deficit.

The Economic Counsellor and Director of the Research Department responded that, from the proposals that had been suggested--a continuation of the income tax cut for an additional year or two, and an increase in consumption taxes--a larger structural deficit would occur for the years of the tax cut, followed by a decline in the structural deficit with the increase in consumption taxes. The staff's policy was to present the tables on the basis of the established policies, rather than on the proposed ones. While the Japanese Government had indicated its intention to do something a bit different from what was presented in the table, the details of that had not yet been made clear.

Mr. Al-Jasser said that if the Fund wished to maintain its influence in the area of capital markets, it would need to rely on a timely follow-up and understanding of the dynamics and evolution of the markets. The integration of capital markets was proceeding very swiftly. As the Fund progressed further in the area of current account convertibility, it should, as an institution, look more seriously at its role in the surveillance of the capital markets, and consequently, at capital account convertibility. It was important that the staff, the management, and the Board think seriously about how the Fund should position itself vis-à-vis surveillance over capital markets.

The Chairman made the following summing up:

> The Board discussion covered a broad range of issues, including recent economic policy achievements in many parts of the world, indications that the world economic slowdown that had begun in 1990 was coming to an end--notwithstanding the still weak conditions in many industrial countries and countries in transition--and the policy challenges that remained in the period ahead. A particularly significant achievement that was emphasized by all Directors was the successful conclusion of the Uruguay Round, which would give new impetus to world trade, increase efficiency in the use of resources, and help to bolster business and consumer confidence worldwide. Directors emphasized the important contribution of increased trade as an engine of economic growth and development in all countries. They stressed that reduced protection in agricultural sectors, especially lower agricultural subsidies in industrial countries, should help to reduce distortions in the pattern of world agricultural production and trade. Many speakers saw the successful completion of the Uruguay Round as the single most important step toward enhancing growth prospects in the period ahead and into the medium term.
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> Directors noted the encouraging progress in implementing several other elements of the agenda set out by the Interim

Committee in its "Declaration on Cooperation for Sustained Global Expansion" in April 1993. Fiscal consolidation programs had been announced in several countries. European interest rates had fallen significantly, and tensions in the European Monetary System (EMS) had abated. Japan had taken further measures to support the economy. Continued progress toward stabilization and reform in many developing countries had allowed robust growth to be sustained, especially in Asia and Latin America. The Fund's new systemic transformation facility had supported the reform process in many of the countries in transition, and some of those countries were experiencing the first signs of recovery.

Against that background, Directors generally concurred with the staff's projections for a gradual strengthening of world trade and activity in 1994-95. At the same time, many Directors emphasized the critical problems that remained for the world economy in generating vigorous and sustainable growth for the broadest range of countries. In many industrial countries, margins of slack remained wide, unemployment rates were high, government deficits remained large, and public debt ratios were still increasing. In addition, long-term interest rates had edged up significantly in recent months despite low actual or expected rates of inflation in most countries. In many developing countries, especially among the poorest, living standards were still falling as a consequence of both adverse external developments and inadequate adjustment and reform efforts. Among the economies in transition, meaningful recovery had begun in only a few, and financial stabilization remained to be achieved in many.

The discussion of economic conditions and prospects for industrial countries highlighted the continuing divergence in cyclical conditions between two groups of countries: in the first group--comprising, inter alia, the United States, the United Kingdom, Canada, Australia, New Zealand, and the Nordic countries--recovery was either well established or clearly under way; in the second group--including Japan and continental Europe--the latest indicators suggested that economic conditions had begun to improve, but the recovery remained fragile. While the evidence of stronger growth momentum in a number of countries was clearly welcome, many speakers expressed concern that the pickup of economic activity in Japan and Europe might occur only slowly, and that expectations for recovery in Europe, in particular, depended heavily on external demand.

Directors saw the widening divergence of current account positions as an inevitable consequence of the disparity in cyclical conditions among industrial countries which should be expected to reverse as cyclical positions became more similar. While significant current account surpluses or deficits could reflect basic inadequacies of macroeconomic or structural policies, which would need to be addressed, Directors felt that moderate surpluses or deficits should not be viewed as undesirable, to the extent that they reflected the efforts of investors to allocate their portfolios efficiently across countries. More generally, Directors stressed that bilateral trade and current account positions were not an appropriate focus for trade policy. They emphasized the importance of settling bilateral trade disputes quickly and, above all, in a manner consistent with multilateral principles.

A central concern of Directors was again the high level of unemployment in many industrial countries and the likelihood that the slow pace of recovery would entail a further increase in labor market slack, especially in Europe. A failure to reduce unemployment to acceptable levels as rapidly as would be compatible with inflation objectives would not only involve large economic and human costs, but it could also threaten the social fabric, erode the credibility of government policies, and jeopardize the achievement of medium-term budgetary and growth objectives. High unemployment also fueled protectionist pressures. Speakers agreed with the staff that a large part of the problem of persistently high unemployment reflected rigidities in the labor market, which had contributed to a marked ratcheting up of structural unemployment rates during the preceding two decades. Comprehensive labor market reforms were urgently needed to reduce significantly the structural component of high unemployment. That was now recognized by the authorities in all countries, and some reforms had recently been enacted, or were being proposed. Nevertheless, much remained to be done to create a public consensus in favor of reform and to improve the functioning of labor markets. Several Directors noted that the strengthening of the economic environment should provide an important opportunity to forge ahead in that area; in that sense, it would constitute an example of what one Director called "using the recovery wisely."

Directors recognized that priorities in labor market reform differed depending on specific features of each country's labor market. They agreed that there was a general need to improve education and training in order to strengthen skills and productivity, in particular of those workers most vulnerable to unemployment. It was also necessary to reform regulations that discouraged hiring or prevented real wages from reflecting the productivity of low-skill or inexperienced workers, and to ensure that social benefit programs did not discourage job search and employment. Many Directors agreed with the view that, by protecting insider beneficiaries at a high collective cost, such social systems and programs frequently contributed, de facto, to growing inequities in society. In that regard, Directors noted that labor market reforms needed to be accompanied by appropriate adjustments to tax and transfer systems to help meet social concerns. Several Directors drew attention to the European Union Commission's White Paper on growth, competitiveness, and employment, and to the conclusions of the recent jobs summit of the major industrial countries.

Directors emphasized that, for all industrial countries, the key short-term macroeconomic policy challenge was to strengthen conditions for a durable expansion that would be sufficiently robust to reverse the rise in cyclical unemployment, while safeguarding the gains made toward achieving price stability.

Directors agreed that the primary responsibility of monetary policy was to maintain price stability where it had been achieved, and to continue to reduce inflation where it was still too high. It was noted that, in the current cycle, the monetary authorities in many countries, having enhanced the credibility of their commitment to reasonable price stability, had had greater scope to lower official interest rates to support activity. There was a broad endorsement of the substantial reductions of official interest rates that had been implemented during the preceding year. There was also broad agreement that in most countries where recovery was not clearly under way, there continued to be some room for short-term interest rates to decline without jeopardizing progress toward price stability. That was seen to be the case in continental Europe in particular. Some Directors also believed that a further reduction of the official discount rate in Japan merited consideration. However, there remained differences of view among Directors on the scope and appropriate pace of interest rate reduction. On the one hand, several speakers--noting the receding inflationary pressures in Germany, and the increased room in many of Germany's partner countries for bringing interest rates into line with domestic conditions following the widening of the exchange rate mechanism (ERM) fluctuation bands--expressed concern that the excessively moderate pace of interest rate reductions in Germany and the rest of continental Europe might stall the recovery of activity. On the other hand, a number of Directors believed that the need to safeguard the credibility of the price stability objective, and the associated goal of exchange rate stability in some countries, justified the cautious and gradual easing of monetary conditions that had been followed to date, and which was expected to continue in the coming months. All Directors agreed on the importance of allowing monetary conditions to tighten sufficiently early in the coming expansion to avoid the need for sharper and more pronounced interest rate increases at a later stage. In that regard, Directors noted that although price increases in the United States had remained subdued, economic slack had been rapidly absorbed. Accordingly, speakers endorsed as timely the U.S. Federal Reserve's recent steps toward monetary tightening. Directors urged the United States authorities to remain vigilant by taking additional measures as required to ensure a sustained expansion with low inflation.

In discussing the framework for the conduct of monetary policy, some speakers noted that the adoption of explicit inflation targets had helped to preserve, or restore, a medium-term framework for monetary policy in countries that had been unable to maintain exchange rate anchors and that had found monetary targets insufficiently reliable. That approach was seen as having met with success in enhancing policy credibility--in particular in Canada and New Zealand, where inflation had declined to very low levels--and in reducing uncertainty about the authorities' objectives in the United Kingdom, Finland, and Sweden, when those countries had felt obliged to abandon their exchange rate peg. Other Directors believed that more experience was needed before a judgment about the merits of inflation targeting could be made. Whatever the approach, all Directors agreed that the monetary authorities had little alternative in their day-to-day monetary management but to rely on a broad range of indicators to judge the extent and timing of changes in official interest rates.

Directors commented on recent developments in financial markets, especially on the recent rise in long-term interest rates. Several Directors noted that spillover effects across national markets, and common factors operating on those markets as a whole, had tended to move yields in the same direction simultaneously. In that latter regard, the relative improvement in actual and expected growth performance was mentioned as a possible common factor that had affected most industrial countries to a greater or lesser extent. A number of Directors suggested that the recent rise in longer-term interest rates possibly reflected an overreaction of financial markets, both in taking rates down during 1993, and in pushing them up more recently. Some Directors emphasized that the increase in long-term rates did not indicate a serious loss of hard-won credibility in the fight against inflation, because at least part of the increase reflected a correction from earlier low levels. However, it was recognized--as a number of Directors noted--that inflationary expectations appeared to have moved higher in some countries where recovery was firmly established, and that that development helped to explain differences in the magnitude and timing of recent movements in long-term interest rates. In light of the strong interest rate linkages across countries, several Directors advocated the need for closer and stronger policy coordination, especially among the major industrial countries.

Regarding fiscal policy, Directors noted that fiscal deficits remained unsustainably large in many countries, and they saw little scope for expansionary fiscal measures to support recovery in most countries where growth remained weak. Indeed, with the level of public debt having risen sharply during the 1980s and early 1990s, Directors stressed that substantial efforts at fiscal consolidation were necessary in virtually all the industrial countries over the medium term. Fiscal policy could best contribute to recovery by reducing uncertainty about future financial conditions through the adoption of specific medium-term programs of fiscal consolidation. In several countries, including the United States, Germany, and the United Kingdom, such programs had contributed to the marked reduction in long-term interest rates that had occurred during 1993. However, substantial further efforts would be necessary in these and most other industrial countries to strengthen national saving and raise medium-term growth prospects. Early steps in that direction were also seen as the best policy response to the recent increase in long-term interest rates. In particular, it was noted that the strengthening recovery in the United States presented an important opportunity to further consolidate the fiscal position. Further efforts at budgetary consolidation and a sound financing of social security and health care reform would best contribute to the dampening of long-term inflationary expectations and forestall further increases in long-term interest rates.

Directors agreed that, in Japan, significant supportive fiscal action had been appropriate in view of the depth of the recession and the considerable progress toward fiscal consolidation that had been achieved during the 1980s. They welcomed the latest fiscal package announced in February 1994, and the recent declarations on the authorities' intentions regarding future tax reform initiatives. There were some signs at present that the downturn had bottomed out, and the latest measures should help to strengthen confidence and promote recovery. A number of Directors, while mindful of the need for Japan to resume fiscal consolidation once the current difficulties were overcome, noted that the present and projected margins of slack remained very large, and they called on the Japanese authorities to ensure that fiscal stimulus would not be withdrawn until recovery was clearly under way.

Directors welcomed the robust economic growth in many developing countries, and they noted that the strength of activity in the developing world had fully accounted for the growth in world trade volume in 1993. Indeed, the growth of developing countries constituted one of the most encouraging aspects of global trends in recent years. However, Directors also pointed to the wide disparities in economic growth across countries. Growth had been particularly strong in the east Asian countries and in China. The experience of countries in east Asia was interpreted as demonstrating the benefits of sound macroeconomic management and outward-oriented trade policies, and was seen to be worthy of further staff study. Strong adjustment and reform efforts had also borne fruit in many countries in the Western Hemisphere, and positive signs were appearing in some of the low-income countries in Africa, but growth remained inadequate in many other developing countries. Directors noted that the resumption of growth in the African countries of the CFA franc zone should be facilitated by the recent devaluation of the CFA franc and the courageous supporting policy measures that were being taken in the context of Fund-supported programs. Several Directors noted with concern that declining oil prices had lowered near-term growth prospects in the oil exporting countries; in that regard, a few Directors regretted that the reduction in oil prices had been offset in many countries by increased taxation of oil products.

Directors welcomed the staff's analysis of the factors that had contributed to the poor performance of many low-growth developing countries, which provided a useful complement to earlier work on the experience of the successfully adjusting developing countries. Directors recognized that there was rarely only one reason for the failure of a country to realize its economic potential, and that an unfavorable external environment had played an important role in many cases. All Directors emphasized, however, that inappropriate domestic economic policies almost always were at the root of low growth performance and consequent stagnant, or even declining, living standards. The absence of a stable economic environment for both private and public economic decision making, high and volatile rates of inflation, underdeveloped and distorted financial markets, excessive government intervention in the economy, high levels of subsidies and protection from foreign competition, overvalued exchange rates, rapidly expanding populations, as well as poor governance, had constituted interrelated obstacles to growth in many cases. Moreover, the effects of these factors had discouraged needed inflows of official financial assistance, as well as private capital, and had aggravated the impact of adverse terms of trade developments on insufficiently diversified economies.

Directors recognized the daunting challenges facing low-growth countries. They stressed that sustained adjustment efforts would be required for several years, with the success of domestic policy efforts also depending on the timeliness of external financial assistance and the realism of debt relief efforts, especially for low-income countries.

A number of Directors expressed views regarding the role of the government in the economy. It was noted that that was another area in which the experience of the east Asian countries merited study. While recognizing the motivation and justification for certain forms of government intervention, especially with regard to investment in infrastructure and human capital, Directors generally warned against the distortionary effects of extensive state involvement in economic activity. In many countries, controls on agriculture had been particularly harmful, often resulting in lower output, and holding back the pace of economic development.

Directors noted that private capital flows account at present for a major proportion of financial flows to developing countries. That was widely viewed as a welcome development, especially for countries with strong growth prospects and stable policy environments. However, Directors emphasized the importance of sound macroeconomic policies to ensure that the capital inflows were invested efficiently and to limit the risk of sudden changes in market sentiment. The importance of capital flows and of capital account developments induced a number of Directors to suggest further work on the experience with capital flows and capital controls. That would include an examination of how to strengthen the Fund's role in promoting capital account convertibility, in addition to its traditional mandate over the current account, where progress in the acceptance of the obligations of Article VIII had been particularly encouraging in the recent period.

Directors noted that for many low-income countries, greater concessional assistance would be required in support of the implementation of strong reform programs and improvements in economic management. In that regard, Directors welcomed the initiation of operations of the enlarged and extended enhanced structural adjustment facility (ESAF), and they were encouraged by the broad support of the membership for that initiative, including of many developing countries. Many Directors also drew attention to the importance for low-income countries of debt-stock reduction operations by official bilateral creditors, and a number of speakers noted the need for deeper debt reduction or forgiveness in particularly difficult cases.

Directors agreed to have a further exchange of views on the economies in transition before the Interim Committee meeting. That discussion would focus on policies planned and followed by the authorities of economies in transition and on the role of the Fund in the elaboration and implementation of those policies, as well as on external financing issues. Therefore, this summing up will need to be supplemented by the conclusions of those forthcoming discussions. At this stage, Directors emphasized that the recent experience of economies in transition in Central and Eastern Europe, the states of the former Soviet Union, and Asia provided clear evidence of the benefits of sustained policies of stabilization and reform, and of the cost of delays in instituting the needed measures. Directors saw as particularly noteworthy the fact that growth was recovering only in those countries that had been successful in bringing inflation down and persevering with major reforms. In contrast, economic activity had continued to contract in other economies in transition. Speakers attributed the further substantial output declines in most countries of the former Soviet Union to ongoing disruptions to interstate trade, failures to implement stabilization policies, and armed conflicts in some countries. Speakers welcomed the formulation of a comprehensive program in Russia, in close cooperation with the Fund staff, and they looked forward to the discussion of Russia's request for the second drawing under the systemic transformation facility in support of that program.

While welcoming the progress made in many economies in transition, Directors emphasized that in most of them, much was still to be done. In many countries, large budget deficits and high inflation remained important impediments to economic recovery. The provision of credits and subsidies to state enterprises, as well as the re-emergence of sizable inter-enterprise arrears, had contributed to delaying the transformation process and to impeding the supply response to price reforms. Successful macroeconomic stabilization would require the steady pursuit of enterprise restructuring and other structural reforms, so that sectoral pressures for subsidies and credits could be brought under control. Directors noted the important advances in structural reforms that had been made in a number of economies in transition, especially in the areas of privatization and tax reform. Further measures in the areas of establishing a stable legal framework and of financial sector reform would be vital to advancing the transition process. Well-targeted social safety nets to protect the most vulnerable groups also had a key role to play in alleviating the social burden of transition at an affordable budgetary cost.

Directors noted that the international financial institutions, other international organizations, individual countries, and private creditors had all contributed to the financing of the transition process. The Executive Directors would return to external financing issues on April 13, 1994, but at the present juncture, Directors welcomed the significant financial support provided by the Fund and, in particular, the successful role played by the systemic transformation facility in fostering stabilization and reform in several economies in transition.

Ms. Lissakers said that it appeared that the staff had had a greater input than the Board in assessing the need for further fiscal consolidation in the United States. She believed that the tenor of Directors' comments had been that the United States should take advantage of the improving conditions to do more, but the weight given in the summing up to the United States and Europe, respectively, regarding what had been done and what needed to be done in that area, was perhaps a bit displaced, in her view.

The Chairman replied that he did not see any lack of balance in the recommendations to the European countries and to the United States. The Europeans had been targeted on the monetary side and on labor market flexibility.

After adjourning at 1:05 p.m., the meeting reconvened at 2:30 p.m.

3. REPUBLIC OF ESTONIA - 1994 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1994 Article IV consultation with the Republic of Estonia and the first review under the 18-month stand-by arrangement approved on September 16, 1992 (EBS/94/61, 3/25/94). They also had before them a background paper on recent economic developments in the Republic of Estonia (SM/94/81, 3/29/94).

Mr. Bergo made the following statement:

> Almost two years after the Estonian authorities established the currency board and launched an ambitious program to stabilize the economy and undertake far-reaching structural reform, there are now strong signs of recovery. The downward trend in the economy was halted in the winter of 1992/93, and was followed by an upturn, gaining momentum toward the end of 1993. The expected GDP growth of 7 percent for 1994 should bring the economy well on its way to sustainable growth of output, employment and real incomes. This stands out as one of the shortest turnaround periods compared to other transition economies, and has certainly reinforced my authorities' determination to persevere with sound macroeconomic policies and to broaden and deepen structural reform.
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> The staff papers provide a well-focused assessment of recent developments in the Estonian economy, as well as of the challenges it faces. The implementation of the current economic program, supported by the second stand-by arrangement, has proceeded well. All quantitative performance criteria for end-December 1993 have been met. In light of the large number of public infrastructure projects likely to take place under the World Bank Public Investment Program (PIP), the authorities request a modification in the performance criteria for the financial deficit and net lending for end-March 1994, to allow a greater amount of general government investment and a lesser amount of net lending than previously anticipated.

Notwithstanding the good achievements so far, Estonia will, over the years ahead, need the continued support of the Fund in formulating and implementing macroeconomic and structural policies. In this connection, my authorities would like to express their profound appreciation for the valuable advice and assistance that the Fund has provided, both in the context of the program and in the reform process in general. As already noted during the last Board discussion on Estonia, my authorities are considering requesting another stand-by arrangement to succeed the present one, possibly in the form of a precautionary arrangement.

One of the crucial factors in Estonia's success has been confidence in the kroon. The kroon has been strong and has become virtually fully convertible in current, as well as capital, account transactions. My authorities intend to accept the obligations of Article VIII during the current program year.

This confidence would not have been possible if the kroon had not been supported by tight fiscal policy. The general government's overall budget was in balance in 1993, and a balanced central government budget has been approved by the Parliament for 1994. The passing of new value-added tax and income tax laws drawn up closely following the Fund technical assistance recommendations, the almost complete removal of subsidies, and a balanced budget are important achievements. Reflecting the efficiency of the tax system and stronger than expected economic recovery, the revenues collected in the first months of this year are clearly above the planned target. In view of this, a supplementary budget will probably be introduced, but only to the extent the additional expenditure is fully covered by additional revenue.

In this connection, my authorities are considering an increase of the pension allocation in order to maintain the real value of pensions. The Government also intends to strengthen and rationalize the social safety net elsewhere, and to ensure that funds are effectively channeled to the most vulnerable groups of the population within the constraints of the overall budgetary objectives.

The staff rightly points to the pickup in inflation in recent months as a cause for concern. While the monthly rate of inflation in 1993 was reduced to an average of 2.5 percent, or approximately 1/10 of the 1992 level, price increases have been larger since last autumn. My authorities basically share the analysis of the staff as to the sources for the inflationary pressures. First of all, it is clear that the rise in inflation could not be attributed to a relaxation in monetary and fiscal policy. Instead, the continued undervaluation of the kroon vis-à-vis the deutsche mark, the recent real appreciation of the

Russian ruble, and the recent rapid growth of real incomes, combined with relatively inelastic supplies in the nontradable sector appear more likely as explanatory factors.

The Estonian authorities acknowledge the importance of proper supply-side policies to reduce the possible costs, in terms of output and employment, that the self-correcting mechanisms of the currency board could generate if inflation remains high, and are of the opinion that the reforms undertaken with regard to the functioning of the labor market are important steps in this direction. At present, we share the staff view that changes in the monetary and fiscal stance are neither necessary nor advisable. My authorities stand prepared, however, to take additional measures to safeguard the policy objectives, should that become necessary. Most emphatically, they would not allow the credibility of the fixed exchange rate and currency board arrangement to be challenged.

In 1993 a surplus was recorded both on the current and capital accounts, leading to increased international reserves. The ratio of foreign direct investment to GDP was 7 percent in 1993--one of the highest in transition economies. Here, Finland and Sweden rank first among the investor countries, accounting for 60 percent of the direct investment made in Estonia in 1993.

However, the current account balance for the last quarter of 1993 was negative, and the trend of rising imports will leave the current account in deficit for this year as a whole. No financing problems are expected, and it should be noted that the focus of foreign loans is shifting toward investment in infrastructure and industry, thus increasing the economic capacity and the export potential in the medium term.

The very liberal trade and payments environment has given a boost to the internationalization of the Estonian economy. On April 1, 1994, Baltic Free Trade Agreement, which is modeled along the lines of the European Free Trade Agreement (EFTA), came into effect. This is a welcome addition to the agreements already signed with three Nordic countries and Switzerland. Free trade talks between Estonia and the European Union have been initiated, and the agreement is expected to become effective at the beginning of next year. The limitations of these agreements in the area of agriculture and textiles which, as the staff points out, are important areas of potential export growth for Estonia, is unfortunate, however, as are the subsidized agricultural exports from the EU and EFTA countries.

Following the banking crisis of late 1992/early 1993, the financial system in general has improved. Banks have become more careful in analyzing their credit decisions and, at the same time, the medium-term lending activity has increased. However, even if the stock of nonperforming loans has declined, it still poses a serious problem for some banks. In the aftermath of the crisis, several bank mergers took place and, as the minimum capital requirements are gradually raised to meet the EU's standard of ECU 5 million, more mergers are expected. It is also noteworthy that all the commercial banks are predominantly privately owned. The authorities are giving high priority to further strengthening the supervision of the financial system, and very much welcome the technical assistance provided by the Fund in this respect. Important here would be the adoption of the Credit Institutions Act and new accounting rules for the commercial banks. Cooperation with internationally recognized auditors has also improved the skills of the banking supervision as well as the commercial banks.

Estonia has made important progress in privatization since the last review. Privatization of small enterprises has generally been completed; however, there are still some delays with the privatization of large state enterprises. The fourth international round of privatization to sell a total of 50 enterprises was opened in March, and additional international tenders for privatization are expected in the future. In this round the Estonian Privatization Agency (EPA) may reserve part of the shares to be privatized later through a public sale, including sale against vouchers. It is perceived that this step could help launch the securities market. In addition, diversification of privatization measures are now actively addressed, including initial public offerings, turnaround management, expanded use of auctions, joint ventures and vouchers.

The restitution process is progressing slowly, although the procedures of handling restitution claims has been expedited. This has also hindered the development of the real estate market, which has pushed property prices to relatively high levels. The authorities are currently working on detailed methods of how to restitute or compensate for property. Additional legislation on the rights of current occupants is also being addressed.

Extending his remarks, Mr. Bergo noted that at a very late stage in preparing to make the formal request to purchase the second tranche under the systemic transformation facility, his Estonian authorities had determined that certain technical changes should be made in the bilateral arrangements between the Bank of Estonia and the Government. That had raised the question of whether parliamentary approval for the purchase was necessary. That matter was now being looked into as a matter of urgency. The final request suggesting a value date would be forthcoming as soon as the issue had been settled.

His authorities very much regretted the last-minute complication, making it necessary to delay the request until those technical and legal arrangements had been completed, and the inconvenience thus created with regard to the Board schedule, Mr. Bergo continued. He hoped, however, that the Article IV consultation and the first review under the stand-by arrangement could proceed as planned, and that the Board would be agreeable to returning to the formal decision on the purchase of the second tranche in the near future.

Mr. Golriz made the following statement:

Economic recovery in Estonia began in late 1993 when GDP turned around following two years of decline. Sources contributing to the turnaround were exports, boosted by improved competitiveness and inflows of capital, resulting from enhanced confidence in the economy. The Estonian authorities should be commended for their achievements under the program and their perseverance in pursuing reform efforts. However, as the staff points out, much remains to be addressed.

The first and foremost challenge for the authorities is curbing inflation which continues to be a serious source of concern. As recent price increases and the fragility of the external sector clearly show, there is no room for complacency: tight financial policy remains critical in Estonia's stabilization effort.

Fiscal policy appears to be broadly consistent with the program objectives, and the government budget recorded a surplus in 1993. Revenue generation seems satisfactory, though it can be improved over time as tax measures take hold and output expands. Public expenditures were also tight, and the staff report details additional measures for reducing government expenses, including transfers and subsidies. A minor concern here is that, while tax receipts are expected to increase owing to the growth of output as well as the improved efficiency of the tax administration, the ratio of tax revenues to GDP is expected to decline. I wonder whether the staff could explain the reason for this. Public spending seems wisely managed as general government spending on goods and services declined in real terms, and subsidies were confined to a few strategic public services. It is encouraging to note that the central government budget in 1994 is balanced, but we wonder whether it would not be advisable for the Government to refrain from additional spending even if revenue turns out to be in excess of budget expenditures.

As fiscal policy is already tight, the credibility of financial policy would mainly depend upon implementing a prudent monetary policy. The authorities have recognized the importance of containing credit expansion to a level consistent with inflation and external targets. To this end, the currency board has to perform the difficult task of building confidence in the banking system by introducing new requirements for banks and encouraging the growth of an interbank network. To promote confidence in the banking system, the authorities need to put in place prudential regulations and improve banking supervision. We fully support the Fund's technical assistance in both areas. On using monetary instruments, we note that, except for reserve requirements, other instruments such as interest rates and open market operations are not widely used, and we wonder whether unfamiliarity is a factor.

Mr. Bergo's informative statement refers to the helpful role of the currency board in stabilizing Estonia's economy. We agree. Looking ahead, however, as a currency board is usually a transitory arrangement for special circumstances, we wonder whether Mr. Bergo or the staff has any comment on its life expectancy.

Turning to the external sector, we note from Table 4 of the main report that export volume has increased by more than 40 percent in 1993 and is expected to increase by another 17 percent in 1994. The staff report indicates that this has largely been due to undervaluation of the kroon. I wonder whether there is any expectation of the rate adjustment.

Estonia maintains a liberal trade regime. At present, imports are entirely free of tariffs and quantitative restrictions, and all exports are free of taxes. Moreover, the authorities have further liberalized the capital account and have formally applied, in early March, to join the GATT. We were also pleased to learn from the letter of intent and Mr. Bergo's statement that Estonia intends to accept the obligations of Article VIII of the Fund. These are steps in the right direction and deserve commendation. Estonia, however, is facing trade restrictions imposed by other countries as referred to on page 16 of the report. Estonia's trade partners, including EU and EFTA countries, should be encouraged to reduce trade restriction against Estonia's exports.

On structural issues, as noted by Mr. Bergo, some welcome developments in the privatization process have taken place: privatization law has been amended, methods of privatization have been diversified, and the restitution process is expected to speed up. In the case of small enterprises, privatization has been proceeding at an appropriate pace, and there is need for more resolute action in the case of larger state-owned enterprises. In this connection, we are please to note that the program for 1994 includes some elements that should help facilitating the process.

Finally, in order to reduce the social costs of adjustments, a social safety net has been designed to protect vulnerable segments of the population. This scheme includes, inter alia, a guaranteed minimum income based on a poverty line established for a single adult, and adjustable for the size of the families. While we understand the rationale of the scheme and broadly endorse the authorities efforts, we are of the view that it could be improved by making it more targeted and more transparent.

The staff representative from the European II Department remarked that, in the light of Mr. Bergo's comments, the staff recommended that the Executive Board proceed with the Article IV consultation and review the stand-by arrangement for Estonia.

One of the changes to note since the staff report had been issued was the rise in consumer prices by 8.9 percent in March 1994, the staff representative continued. The jump in the monthly rate from 5.5 percent in January and 5.2 percent in February reflected the authorities' continued policy of administered price increases designed to eliminate many implicit price subsidies. For example, in March, the rents in the Tallinn area were doubled, the prices of telephone calls and railway tickets were raised by 75-100 percent, and the charges for hot water and sewage were increased by 35 percent. The authorities estimated that those price increases had contributed about 4.7 percentage points to the overall inflation in March. Thus, the measured inflation rate, excluding administered price increases, remained at around 4 percent for the fourth consecutive month.

Mr. Dorrington made the following statement:

Estonia's economy has well and truly turned the corner, and it is heartening that the sound policies being adopted are now resulting in strong economic growth. The 7 percent growth forecast for 1994 is welcome news indeed. Estonia continues to be an example for the rest of the countries of the former Soviet Union to follow.

The frequency of recent Board discussions on Estonia, combined with the fact that Estonia consistently meets its performance criteria, might run the risk of the staff papers becoming rather stale. However, this is certainly not the case, as there continue to be a number of interesting issues in the analysis of economic performance to date, not least the staff's analysis of the current causes of inflation, on which I will say a little more in a moment.

I welcome the authorities' continued fiscal prudence and the firm adherence to currency board discipline. The authorities have kept fiscal policy admirably tight despite a deep recession. That firm resolve will need to be maintained with the projected recovery. There is likely to be significant further pressure on the government budget arising from an increase in unemployment payments from further labor shedding. Employment has only fallen by 12 percent over the last four years, in contrast to a GDP decline of 34 percent. The low level of official unemployment is at least in part a reflection of the relatively slower progress on structural reform to date, although I also recognize the contribution of flexible labor markets.

While on budgetary issues, I note the progress made on tax compliance, which is an essential feature of a well-ordered economy. I do not underestimate the difficulties of the starting position. I was particularly pleased to see that the majority of Fund technical assistance recommendations were accepted and implemented. This encourages me to support further Fund technical assistance in areas where it is still needed. I was particularly pleased to see that the differential treatment of foreign investment has been repealed. In general, reforms to personal taxation appear now to be well in hand, although there remains scope for further reform of corporate taxation.

The resurgence of 5 percent monthly inflation is certainly a cause for concern. The staff has presented a very interesting analysis of this. I broadly agree with it, although I am less sanguine than the staff that this inflationary pressure will be self-correcting for three reasons, on which I would welcome staff comments.

First, the real value of the ruble vis-à-vis the kroon is exogenous as far as Estonia is concerned. While I agree that continued real appreciation of the ruble appears unlikely, there would be risks to the program if this trend continues.

Second, there is a risk that the projected growth in real income will continue to fuel domestic demand and inflationary pressures in the nontradable sector.

Third, related to the inflationary contribution of the undervaluation of the kroon, instead of the equilibrium price level being approached asymptotically there is a risk that inflation momentum will result in some overshooting. Thus, I am not convinced that inflationary pressures will abate quite so easily as the staff seems to suggest when the real value of the kroon reaches its equilibrium level.

Nevertheless, I certainly endorse the staff conclusion that it is crucial to increase flexibility through active, but not interventionist, supply-side policies.

In this context, I would encourage the authorities to accelerate the privatization program. The staff paper rightly points out that this is crucial for achieving sustainable growth. Faster privatization would also speed up the process of labor shedding and its reallocation to more productive uses.

I welcome the efforts being made by the Bank of Estonia to restructure the banking sector and agree with the recommendations in the staff appraisal. There were some positive developments last year: lending to the private sector increased substantially, maturity of loans lengthened, and spreads between lending and deposit rates fell. But spreads remain high and confidence in the banking system remains fragile. The suggestion of averaging and remunerating reserve positions is certainly worth pursuing.

I have three additional points on the balance of payments. First, the projected surplus on nonfactor services looks very large, growing by 150 percent to the year 2000, reflecting expected buoyancy of both entrepôt activity and tourism.

Second, the projected deterioration in the current account, expected to be more than adequately financed by foreign direct investment and other capital inflows, underlines the need to do everything possible to maintain external confidence in the economy.

Third, I would welcome the staff's views on the adequacy of reserves in the context of a currency board. Estonia currently has reserves equal to around five months of imports, of which three-and-a-half months are required for 100 percent backing of domestic base money. This leaves one-and-a-half months of what might be called free reserves. The forecasts imply total reserves of around three-and-a-half months by the end of 1994, in part reflecting higher import demand; I am not sure exactly what this implies for free reserves. In assessing the adequacy of the level of reserves should we concentrate on total reserves, or only on free reserves, or are both irrelevant provided that there is always 100 percent coverage provided for the currency board.

Related to this is the question of the future relationship with the Fund. Mr. Bergo talks of a future stand-by arrangement, possibly precautionary. This seems to imply a choice between a facility which will almost certainly be drawn, or almost certainly not be drawn. Another option that might be appropriate is what might be called a classical stand-by arrangement, to be drawn if and when needed. Also, as it is clear to me that there will need to be a continuing close relationship with the Fund for a number of years, I wonder why a stand-by arrangement rather than an extended Fund facility arrangement is being considered. Or is there a possibility of some form of relationship not involving access to Fund resources? I raise this as an open question, and not to push any particular option. I would welcome further comments from the staff or Mr. Bergo.

I have three final comments. I welcome the intention to accept Article VIII status soon; second, I support all the proposed decisions; and, third, I presume that the systemic transformation facility decision, when it can be taken, will be circulated on a lapse of time basis.

The Acting Chairman fully agreed with Mr. Dorrington that the systemic transformation facility decision should be issued on a lapse of time basis.

Mr. Blome made the following statement:

I agree with the staff and previous speakers that Estonia has achieved remarkable progress in the past two years, and can now be regarded as a textbook case for a successful transformation process. Although I do not have the time to enumerate all attained improvements, I still want to highlight a few especially impressive results, namely the considerable increase in productivity, the strong growth of exports to industrialized countries, and the fact that the kroon has become virtually fully convertible. In addition, I welcome the fact that the Fund-supported program has remained on track and the news that all quantitative performance criteria for end-December 1993 were met. All these achievements deserve our commendation.

There are, however, still some clouds on the horizon. The staff has rightly pointed out that the recent upturn in inflation, the slow pace of large-scale privatizations, and the continued fragility of the banking system pose risks for further recovery and growth. It is clear that these problems must be addressed in the next stage of the Fund-supported program. To this end, the staff has made a number of proposals that I can broadly support, especially those aiming at an acceleration of structural reform. However, I do not share the staff's confidence that inflationary pressures will soon begin to subside. Therefore, I wonder whether somewhat stronger financial policies than recommended by the staff may not be advisable in order to ensure adequate progress toward price stability within a reasonable period of time. Let me explain my position in greater detail.

To combat inflation, the staff recommends enhancing supply-side policies in order to improve, first, the flexibility of prices and wages and, second, the efficiency with which labor and capital are utilized. While agreeing that such policies are highly desirable, I assume that it will take some time to implement these reforms and that it will take even more time until these reforms will lead to the hoped-for results. The same may hold true for a similar point. The staff is of the opinion that an interventionist monetary policy against inflation is neither necessary nor advisable because of the self-correcting mechanism built into the monetary regime. However, this self-correcting mechanism, too, works only with a considerable time lag, which means that monetary expansion is only reversed after the existing demand pressures have led to a current account deficit and a subsequent decline in reserves.

Against this background, the question arises whether monetary policy could not play a more active role with the view of alleviating and shortening the stabilization process. In this context, I note that major monetary indicators may suggest that monetary policy is presently too accommodating, especially the strong growth of broad money--six times as high as real GDP growth--and the fact that interest rates remain considerably negative in real terms. The authorities should thus examine whether a limited strengthening of monetary policy may be useful, for example by increasing reserve requirements.

Such an approach could be complemented by further fiscal restraint. While noting that the financial balance of the general government might turn into a deficit of 1.1 percent of GDP in 1994, according to the projections on page 29 of the staff report, I wonder whether the authorities should not aim rather at achieving a limited surplus so as to dampen temporarily domestic demand. In this context, I support Mr. Golriz's recommendation that the government should refrain from additional spending if revenue turns out to be higher than expected, which does not seem unlikely according to Mr. Bergo's helpful statement.

Still on fiscal policy, but more as an aside, I wonder whether it would not be advisable to replace the statutory flat rate of 26 percent of the personal income tax by a progressive tariff. This could also be a useful tool to combat excessive wage increases. On expenditure, I welcome the authorities' intention to rationalize the social safety net. According to newspaper articles, many Estonians seem to have found employment in the small-scale enterprises of the booming parallel economy, and unemployment may be lower than reflected in the official unemployment statistics. Therefore, there may be no need to further support some segments of the economy.

Let me add two brief comments on structural policies. Here, I would first underscore the need to rehabilitate the banking sector along the lines proposed by the staff. In this context, I also want to support the staff's view that the financial resources of the Bank of Estonia should not be involved in support of any commercial bank. This is a necessary precondition for preserving the integrity of the currency board. Finally, on enterprise restructuring, I share the view that privatization of large-scale enterprises should be accelerated. However, progress in this area may be greater than expected. An expert from the German privatization agency, who works for the Estonian Government, recently came to the conclusion that enterprises involving two thirds of the industrial capacity have already been privatized. In addition, the head of the Estonian privatization agency has recently announced his intention to broadly complete the privatization process by the end of this year. This information is very encouraging and I wonder whether the staff could confirm it.

Mr. Ryan made the following statement:

Estonia is beginning to experience the fruits of its adjustment efforts as the turnaround in output begins to take hold. Growth began to surface in the second half of last year and is expected to reach 7 percent in 1994. Foreign direct investment has jumped substantially. As economic activity picks up and inflation subsides, real wages have begun to grow. This is good news for the employment picture, which has been cushioned from the fall in output by the shrinkage in the labor force--owing mainly to emigration--but is still experiencing an estimated jobless rate of some 8 percent.

Among the ingredients in Estonia's success, the demonstrated commitment to macroeconomic stabilization, anchored by the currency board, is the cornerstone. Inflation which had been running at over 1,000 percent as recently as two years ago, has been substantially reduced and brought under control. As explained in the staff report, the continued pressure on prices results from factors unrelated to financial policies, but rather undervaluation of the kroon, real appreciation of the ruble, the upturn in demand, supply rigidities, and increases in administered prices. This analysis appears reasonable, but points to the need, as the staff report notes, to avoid letting inertial price and wage momentum develop, which might lead to an overshooting of the real exchange rate and, subsequently, more abrupt adjustments. The report notes that price pressures could persist, but points to some reassuring indicators of a decline in inflationary expectations, including the inverted yield curve and substantial drop in income velocity of broad money.

Unfortunately, confidence in the currency has not been matched by similar confidence in the banking system. This has increased the onus on the authorities to maintain a tight fiscal stance. The importance of ensuring the integrity of the currency board requires prudent fiscal management as a matter of course, and the added burden of an unreliable banking sector has made it doubly important that no, or very little, domestic financing of the fiscal account occur. Under the best of circumstances, domestic financing would entail some crowding out of private investment. Under recent circumstances, it is not clear that the banking system would accommodate even modest government financing needs without an exaggerated crowding-out effect on private borrowers, thus threatening confidence in the integrity of the currency board. Banks would likely welcome the opportunity to hold risk-free government assets, but the impact on the private sector could be damaging. This in turn could lead to pressure for more government intermediation, hardly the direction intended by the authorities.

The strong fiscal performance to date is therefore especially commendable. A balanced budget has been passed for 1994, and care will need to be taken to meet this target. On the revenue side, the streamlining of tax rates at lower levels appears sensible. As the staff has noted previously, however, tax policy changes can only go so far in ensuring satisfactory revenues; the more cumbersome and difficult task of improving tax administration and compliance is essential to meet revenue goals. I wonder if the staff could comment on progress in this respect. We note the passage of tax laws with the 1994 budget, but would appreciate a better sense of how Fund recommendations on the administrative side are being adopted. Tax evasion appears to be an ongoing problem, particularly in the emerging private sector.

On the expenditure side, we concur with the staff on the need to hold the line against further wage increases. We are encouraged to see that the External Financing Board (EFB) is to become operational and will begin to direct some outside funds through private intermediation channels. We do wonder, however, what the impact of such on-lending might be on bank capital ratios. The challenge is to use this opportunity to enhance banks' credit evaluation and prudential practices.

The banking sector has strengthened, but not as quickly as one might hope. We agree with the staff on the need for the banking department of the Bank of Estonia to not provide emergency assistance for nonliquidity related purposes. Recapitalization of banks should be handled through the budget. To the extent that bank supervision has fallen short in speeding the repair of bank balance sheets, the need to rely on market discipline is accentuated. Great care must be taken not to dilute this discipline and raise questions about the use of Bank of Estonia surplus reserves. There is a moral hazard to such bailouts that the authorities appear to recognize, and we hope the assistance provided the North Estonian Bank is indeed a one-time event, as is reflected in the letter of intent.

In mentioning the need to improve banking supervision generally, the staff report specifies enforcement of regulations on commercial banks' foreign currency exposure. I wonder if the staff might elaborate on their concerns in this area.

One area that is not encouraging, however, is the slow pace of privatization, particularly for larger enterprises. The staff report notes some progress in accelerating efforts in this regard, but overall prospects remain rather hazy. Further legislation and administrative clarifications are apparently needed to remove various bottlenecks to divestment, but there does not appear to be the sort of impetus behind these steps one might expect. Can the staff or Mr. Bergo offer a sense of how the authorities plan to move in this area? Are there timetables for needed legislative action? The staff report notes that much of the inherited capital stock is now obsolete, so one wonders whether privatization or liquidation will be the more realistic course in various circumstances. One would hope that increased dynamism in the private sector, including foreign direct investment, will serve to accommodate the labor shedding that will inevitably result as larger enterprises are spun off.

Finally, a couple of points on trade. We note the surge in exports to the countries of the former Soviet Union that is attributable largely to the real appreciation of the ruble, but wonder if this is also an indication of any pickup of growth in the countries of the former Soviet Union. Second, we are again troubled to read of the disruption caused to Estonian agricultural exports and home market sales from subsidized exports from the EU and EFTA. Estonian textile exports also face restrictions. As we have said before, restrictive European trade policies pose difficult obstacles to an already difficult adjustment process.

With these comments, we can support the proposed decisions, as amended.

Ms. Vori made the following statement:

The stabilization of the Estonian economy under the current program is progressing successfully. The country has responded positively to firm budgetary and financial policies and, after a rapid initial adjustment, economic activity has rebounded, led by the good performance of exports. Adherence to the stabilization effort of the vigorous fiscal policy has helped to enhance the credibility of the fixed exchange rate and currency board arrangement, leading to the rapid disinflation economy. Trade and price liberalization have proceeded hand in hand with the implementation of market-oriented structural reforms. I expect that the Estonian authorities soon will be able to advance further in the process of reforming the economy so as to complete the country's transition to a market based system.

The Estonian authorities are well aware of the crucial importance of restrained fiscal policy in their strategy aimed at fostering macroeconomic stabilization in the context of fixed exchange rate arrangements. Indeed, the track record of the authorities with regard to the fiscal accounts appears impeccable. All of the benchmarks have been respected and the balanced budget has been approved for 1994.

On the revenue side, the simplification of the tax structure seems to have been absorbed with only a slight reduction of collected receipts. Further reforms already approved for 1994 should help improve the efficiency of the tax system, although some efforts are needed to strengthen administrative procedures in order to ensure greater compliance by the emerging private sector and to reduce enterprise arrears on social security taxes.

On the expenditure side, I note in particular the abolition of subsidies which is welcome as it eliminates distortions in the economy and helps maintain expenditure restraint.

Concerning the issue of income support, the Government has introduced a new program which is intended to guarantee a minimum income corresponding to the poverty line. As stated by Mr. Bergo, the authorities' goal is not just to strengthen--but also to rationalize--the social security system. In this respect, the current targeting system should be reconsidered in order to improve its overall efficiency.

I concur with the staff that the current rise in inflation in Estonia cannot be attributed to inappropriate fiscal or monetary policies, but instead is due to a combination of other sources such as external factors, structural rigidities in the tradable sectors and the adjustment to price liberalization.

I would also agree that addressing the rising inflation by letting operate the self-correcting mechanism built into the currency board arrangement would be neither efficient nor desirable, as it could imply a high cost in terms of output and employment loss. Therefore, the problem should be addressed without delay by alleviating supply bottlenecks and improving the economy's flexibility.

On the first point, I note the favorable contribution of foreign direct investment, which should be further encouraged by eliminating remaining impediments, and of the large program of public investment, financed by foreign disbursements.

On the second point, I welcome the authorities' efforts to enhance wage and price flexibility through the adoption of measures aimed at improving the functioning of the labor market.

However, preventing the development of an inertial effect on wage formation is a crucial element of an inflation control strategy. The Government has abandoned its income policy and has decided instead to promote the decentralization of wage bargaining. In the absence of any government involvement, I wonder whether the budget constraints faced by both private and nonprivate enterprises would be sufficiently hardened so that the wage increases awarded would be compatible with productivity gains. I have noted, for example, that interenterprise arrears have not declined in the past year, and I would like to hear from the staff on this point.

As noted in Mr. Bergo's statement, in spite of some improvement in lending activity, the situation of the fiscal sector remains fragile. I welcome the measures taken by the authorities to improve the stability of the banking system by enhancing its prudential supervision activity. The efficiency of Estonian banks also needs to be improved. I would favor the staff proposal to allow some mobilization of the obligatory reserves, which could help reduce cost of managing them. The large spreads between lending and deposit rates reflect both a high risk premium on lending and an insufficient degree of competition which calls for further restructuring of the banking sector. Progress in privatization has been slower than expected, owing to the difficulties in completing the prerequisite institutional legislative actions--in particular, privatization of large-scale enterprises has lagged behind. However, the authorities are making efforts to accelerate the disposition of public enterprises through the launching of a new international tender round and by making proposals for a clarification of existing legislation in order to eliminate the potential confusion and delays in the privatization process.

In concluding my remarks, I would like to reiterate my appreciation for the strong commitment of the Estonian authorities to a very difficult and demanding task. The accomplishments need to be further consolidated in the future. The Fund will provide valuable advice and assistance to help the country graduate from a situation of dependence on external financing either through a precautionary arrangement, as suggested by Mr. Bergo, or possibly through some other form of enhanced surveillance of the economic program that does not entail use of resources. With these comments, I support the proposed decision.

Mr. Desruelle made the following statement:

As previous speakers mentioned, it is very pleasing to see that the economic performance of Estonia continues to be very satisfactory and to note, in particular, that output growth seems to be firmly taking hold. Obviously, the authorities must again be commended for pursuing the strong macroeconomic policies that have made this possible.

I am, like previous speakers, somewhat concerned by the increase in inflation in the second half of 1993. I fully accept the point of view of the staff that this rise was not due to a relaxation of financial policies, and, consequently, that its origin must be found in external factors. The staff clearly identifies two such factors, the strong demand for Estonian exports and the real appreciation of the Russian ruble vis-à-vis the deutsche mark.

From this analysis, how should we assess the prospects for inflation? And what can the authorities do about it? As to the prospects, like Mr. Dorrington, I feel more hesitant than the staff to forecast a sustained and fairly rapid decline of inflation throughout 1994 and I do so for basically the reasons Mr. Dorrington exposed--the difficulty of forecasting evolution of the ruble on the one hand, and the fact that it is quite possible that the undervaluation of the kroon vis-à-vis the industrial countries has run its course. This is, however, highly uncertain given the continued transformation of the economy and our very imperfect knowledge of what is an equilibrium real exchange rate. I would welcome additional comments by the staff on the reasons for their confidence in an inflation decline.

As to the question of what the authorities can do about the prospects for inflation, under the currency board system and the present fiscal policy, I would say not much can be done. Fiscal policy is already quite strict and, thus, I agree with the staff, additional fiscal restraint is not warranted. As to monetary policy, its margin of maneuver is rather limited under the currency board system. Reserve requirements could be used to affect the ratio of broad to narrow money but one must note that actual reserves are already at a very high level. One is then forced to conclude that, under the present circumstances and arrangements, the authorities are hostage to external developments.

This lack of margin of maneuver is a well-known characteristic of the currency board arrangement. It is, as a matter of fact, one of its appeals, as it helps build policy credibility; however, it is also one of its drawbacks. Overall, it must be said that, so far, the currency board has served Estonia very well. It nevertheless would seem logical that, as time passes, as structural reforms become more entrenched, as the recovery takes further hold and latent demands for soft policies subside, as a track record of currency stability is established, and as patterns of trade become more established, it would seem logical that the weight of arguments in the choice of monetary and exchange regimes would shift in favor of the benefit of additional margin of maneuver and better adaption to the actual trade structure. I would very much welcome the staff's comments on that issue.

To conclude on other aspects of the program, I would like to enquire about two issues, wage policy and the financial sector.

On wages, I note that the Government is no longer intervening in wage determination and that the staff welcomes that development. Yet, as we are told that the process of privatization will still require time, the question arises as to whether public enterprises, on their own, will take appropriate decisions on wages. Thus, is it the view of the staff that the fairly hard budget constraints to which public enterprises are subjected are enough to prevent any slippage on wages? In particular, is it the view of the staff that, in spite of the uncertain ownership structure, the risk of "consuming capital," which was much highlighted in other countries, is limited in Estonia?

On the financial sector, I note the information given by the staff on its remaining fragility and I welcome the efforts made to strengthen it, including through the technical assistance provided by the Fund on banking supervision. Strengthening the banking sector, obviously, has to be a priority. Therefore, I would like to know whether there is a case, and a possibility, to increase technological transfer through increased activities of foreign banks in Estonia and whether activities of development institutions in that area, including the "possible" World Bank lending operation on enterprise and financial sector reform, should be speeded up.

Finally, a very brief comment on trade, which I initially did not intend to make, as it seems to me absolutely obvious. This comment is that by far the most important element in the picture of trade with countries other than those of the former Soviet Union is the incredibly rapid increase of flows between Estonia and European countries, and the benefits that all trade partners obtain from it.

Mr. Lvin made the following statement:

I am pleased to use this opportunity to express once again our admiration for Estonia's excellent performance in its transition process.

The helpful and very instructive staff papers provide us with ample evidence of success. First of all, there is the clear turnaround in the GDP growth rate, which is expected to reach a sizable level of 7 percent in 1994. A genuine surge in direct foreign investment in 1993 far outpaced forecasts--one may recall projections of $16 million made in the staff report one year ago--and amounted to $144 million, thus reflecting investors' confidence in the authorities' policy stance.

All performance criteria have been met, including the most essential performance criterion in my view, namely, integrity of the currency board mechanism. The fiscal position remained strong over the whole year and a very cautious and conservative approach to the 1994 budget is being adopted. These achievements are clearly linked one to the other: adoption of a currency board arrangement required a fully balanced state budget; in its turn, full backing of base money by foreign exchange effectively eliminated the central bank's lending capacity and substantially improved the Government's position in resisting new expenditure requests.

As far as the recent rise in the inflation rate is concerned, I agree with the staff's view that it is by no means the authorities' fault. Given the significant undervaluation of the kroon, some future price adjustment seems to be unavoidable as an exchange rate adjustment is ruled out. Therefore, contrary to some speakers, I do not see this rise as a matter of serious concern.

As I am in broad agreement with the staff appraisal, I would like to limit myself to two issues: first, creation of an environment conducive to free entrepreneurship, and second, developments in the banking sphere.

In the first area one must give the authorities credit for the substantial progress achieved. The streamlining of tax regulations and the simplification of their structure, the unified treatment of domestic and foreign-owned firms, and almost complete abolishment of restrictions on capital account operations, all together had a positive impact on the recovery of economic activity.

What needs to be praised in particular is the authorities' approach toward wage setting in the economy. I think that it was mainly owing to the authorities' commitment not to interfere in wage bargaining, along with a policy of nongenerous unemployment benefits and tight eligibility criteria, that Estonia was able to avoid both mass unemployment and the loss of competitiveness. Should this policy be maintained in the long term, Estonia would gain a permanent advantage relative to other European economies that have built-in--and quite obsolete--mechanisms of wage and labor regulation. In this regard, I wonder whether such a policy stance is reflected in legislation, or whether it is merely a residual of broken tripartite negotiations. The latter option may prove unsustainable in cases where some formal institutions of state supervision over wage and labor relations did not cease to exist, but were only temporarily weakened. The staff's comment on this would be welcome.

Foreign trade regulation is, undoubtedly, another issue of great importance for an economy as small as that of Estonia. The steady abolishment of export and import duties and restrictions should be strongly commended in this regard. This chair is particularly delighted to notice the termination of tariff discrimination against some Russian agricultural commodities; it is our hope that, should the current ruble/kroon real exchange rate changes not favor Estonia, this unwarranted discrimination would not be restored. As I am of opinion that even the unilateral removal of trade barriers definitely benefits an economy, I urge the authorities to complete Estonia's transition toward free trade and to speed up the replacement of remaining tariffs by unified excise taxes. By the way, it is not clear from the staff report whether or not the special 1/2 of 1 percent import and export fee is still in place and, if so, whether it is expected that it will be abolished. Another question is where the value-added tax on imports is collected--at the border or at the point of sale. The transition to levying a value-added tax at the point of sale may cause one-time losses for the budget. However, it seems quite wise effectively to abolish customs services and to maintain border controls with respect to security issues only.

Privatization is another way to boost private activity. I welcome the authorities' move to simplify procedures for the small-scale privatization and streamlining of privatization agencies' activities. However, the voucher system in Estonia looks somewhat excessively complicated and might cause undesirable frictions in the course of implementation, because it links benefits to working years of individuals. Moreover, I am not sure that it is necessary to include housing privatization in the general voucher scheme. Our experience shows that there are quite strong implied property rights of city dwellers with respect to their apartments; to divest them free of charge and to reward, if necessary, those seeking restitution with some kind of securities may appear the easiest solution. Finally, considering privatization, I was disappointed to find no attempts to deal with privatization of land. Could the staff explain the reason for taking this issue off the authorities' agenda?

Turning to the second area of my interest, namely, developments in the banking sphere, I must acknowledge the extremely cautious approach of the authorities to this issue. Such an approach seems to be fully justified at the early stage of the transition. Estonia's experience proves, once again, that the most efficient means to support sound banking is to limit the state's guarantees to banks. Apparently, both the banks and the public were impressed by the authorities' stance during the 1992 bank crisis and have demonstrated very welcome vigilance in their behavior as witnessed by an initially slow pace of interbank lending and a preference by the public for the legally backed currency.

This prudence has clearly begun to bear fruit. The trends in deregulated interest rates and loan maturities are very impressive--lending rates are steadily moving down and the shares of medium-term credit in lending and of the private sector in borrowing are growing. Moreover, the share of nonperformance loans in the banks' portfolios has stabilized at a rather low level, or has even declined.

I would like to commend the Bank of Estonia for its remarkable achievements in enhancing the payment system, allowing for a sharp decline in the float, which is very typical of the countries of the former Soviet Union. Its role in providing prudent supervision also cannot be overestimated. I agree with the staff that, as habits of sound banking are becoming the custom in Estonia, reserve regulations might be modified in order to provide more room for expansion of interbank trade.

However, the authorities' intention to perform a new bank rescue operation--in fact, already the second one in little more than one year--is a source of serious concern. The idea of having the Bank of Estonia involved in this operation--though, reportedly, on a one-time basis--is particularly worrying. I urge the authorities to reconsider this scheme once more in order to avoid undesirable moral hazard effects. A more aggressive approach toward privatization of the remaining state banks--the Savings Bank and the North Estonian Bank--may be recommended as a viable solution. It is interesting in this regard to find out what happened to the Tartu Commercial Bank, which closed down a year ago. Have all its branches already been sold? What is the situation regarding its idea of establishing a Postbank as a competitor to the Savings bank?

With these remarks, I might add that I see no difficulty in supporting the proposed decisions, excluding that related to the systemic transformation facility. I agree with Mr. Dorrington that this last decision could be made on a lapse of time basis. My hope is that the authorities can consolidate their courageous efforts in transforming Estonia's economy in order to sustain the recovery and growth.

The staff representative from the European II Department, responding to those who had questioned whether the staff was overly optimistic in its judgment on inflation in the coming months, noted that the staff believed that the inflation rate would drop. Owing to uncertainties such as the ruble effect, however, the staff had not stated in the text of the report precisely how large the drop would be. The ruble had appreciated about 120 percent in real terms against the kroon in the second half of 1993, and had depreciated by roughly 15 percent in real terms since the beginning of 1994. As previous speakers had pointed out, such an effect was beyond the Estonian authorities' control. In its report, the staff had assumed that no further real ruble appreciation would occur, and, as a result, that the recent increase in the inflation rate would basically disappear, although with a lag of two to four months.

The staff report had also pointed out that, as income in Estonia continued to increase, upward pressure would mount on the price of nontradable goods, the staff representative continued. If the growth of income was greater than the staff had anticipated, ceteris paribus, inflationary pressures would be even greater. With respect to the further real appreciation of the kroon vis-à-vis other industrial countries' currencies, the extent to which further convergence could take place would be difficult to measure. The staff believed that convergence had almost run its course; nearly two years had passed since the currency board had been established and the exchange rate had been fixed. Nevertheless, as the staff report indicated, overshooting of the real exchange rate was a risk that should be considered.

As he had indicated in his opening remarks, the considerable increase in inflation in March 1994 was the result of large, administered price increases, the staff representative noted. In 1992, when other prices were liberalized, because of social factors, the prices for rents and household utilities were not increased. The staff did not see the price increases as underlying inflation, but, rather, as step increases. Moreover, the greater the increases now, the less there would be for the future.

On supply-side policies, on the one hand, it was important to push forward quickly in the privatization process, the staff representative remarked. On the other hand, the effects of the benefits of those policies would be delayed.

Budget constraints on enterprises were not completely tight, the staff representative observed, but, unlike many former Soviet Union countries without currency boards, Estonian enterprises did not have access to direct credit from the central bank, and the amount of subsidies that were allocated to enterprises from the budget was minimal, which was highly unusual. However, like other countries of the former Soviet Union, many--although the magnitude was indeterminate--nonperforming loans to enterprises were being rolled over, and that could be considered a loosening of hard budget constraints on enterprises. For that reason, the staff report had emphasized the importance of strengthening bank supervision, of clearly defining nonperforming loans, and of obtaining more information on the system of accounts. Overall, the budget constraints for enterprises in

Estonia were much harder than in other countries of the former Soviet Union, and the staff was optimistic that wage increases would not be inflationary.

As interenterprise arrears had remained constant in nominal terms over the past few months and had fallen in real terms, the staff did not see the issue of arrears as a problem, the staff representative observed.

In reply to Mr. Blome's question whether privatization had moved significantly faster than the staff report suggested, the pace was difficult to quantify, the staff representative noted. Taking into account the data on privatization under government programs, the information on the massive amounts of foreign direct investment, the data on the ratio of privatization to GDP, and the incomplete data on the newly established private enterprises, it was possible that, as Mr. Blome had suggested, two thirds of the industrial capacity had already been privatized. Unfortunately, the staff could not provide a precise answer.

On the topic of fiscal policy, much technical assistance was being provided by the Fund and other external advisors in the area of tax administration, and the authorities were implementing their recommendations, the staff representative commented. As a Fund mission had suggested, the National Tax Board would be restructured along functional lines. Moreover, an external consultant contracted by the Fund, who had begun work in the first quarter of 1994, would visit Estonia on a quarterly basis, and he would advise and assist the authorities in devising a longer-term plan for tax administration. Furthermore, the U.S. Treasury had two permanent advisors in Estonia at the Ministry of Finance working on tax administration.

Responding to Mr. Dorrington's question of whether the level of reserves would be adequate for 1995 when reserves in terms of import coverage were expected to fall, the staff representative remarked that whether reserves rose or fell, the currency board arrangement was committed to providing full coverage. The amount of net reserves not covered by the arrangement, the free reserves, was quite small relative to total reserves, was determined by the growth in the net profits of the Bank of Estonia, and was expected to grow only slightly over time.

In the staff's projections, total net international reserves were expected to grow to around $450 million from approximately $375 million in the course of 1994, the staff representative added. During that period, the coverage of imports would fall from five months to three-and-a-half months, because imports were expected to grow rapidly. For 1994, the staff saw no apparent danger that the currency board would not have full coverage and that had been taken into account in its projections.

In the first quarter of 1994, trade with the countries of the former Soviet Union was likely to grow, but mainly as a carryover effect from the export growth from the appreciation of the ruble vis-à-vis the kroon in the latter half of 1993, the staff representative said. However, for the rest of 1994, the rate of trade growth with these countries was not likely to increase. In the medium term, as economic growth in the states of the former Soviet Union increased, Estonia's exports to that region would also increase.

Although the trade unions, which were weak, were advocating tripartite negotiations with respect to the wage bill, the Government had assumed a "hands-off" position, and its stance appeared to be neutral, the staff representative commented. The staff did not see any fundamental change in the current situation for the foreseeable future.

The staff was concerned that there be no institutionalization of indexation mechanisms, so as to keep inflation low, the staff representative said. In discussions with the staff, the authorities stressed their commitment to not allow social expenditures or wages in the budgetary sphere to grow too rapidly and to keep a balanced budget in terms of the domestic financing requirement.

Responding to those who had suggested that, because inflation had been accelerating over the past half year, a more prudent fiscal policy would be to run surpluses on the budget, the staff considered that the authorities should avoid fine-tuning fiscal policy, the staff representative remarked. In the present situation, in the midst of the structural reform process and lacking reliable economic data, it would be risky to do so.

Nevertheless, in the first two months of 1994, the budget had run a substantial surplus of roughly 4-5 percent of the staff's rough estimate of GDP in that period, the staff representative continued. It was unlikely that a new, supplementary budget would be agreed on until May. If the budget included increased expenditures, their effects most likely would not be felt until a few months later. If revenues grew more buoyantly than assumed in the current budget, a small surplus was likely by the end of the year. That surplus would be helpful, but the authorities should not try to use it as a policy goal, taking into account the aforementioned risk.

The underlying premise of the currency board was that the authorities not interfere actively in monetary policy, the staff representative from the European II Department observed. For example, the staff was concerned that, in the circumstances, if the authorities started changing reserve requirements or tried to dampen demand in other ways, when the situation later were to change and output stagnate, the authorities would be pressured to act in the opposite direction. Over time, in this way the currency board would be abandoned and a more active monetary approach would be taken.

Mr. Desruelle praised the staff representative for his explanation of the monetary policy issue as one of rules versus discretion. He asked the staff how long would rules, such as the currency board, be applied in Estonia.

The staff representative from the European II Department replied that currency boards were not inherently a temporary solution. For example, Hong Kong had had a currency board for about a decade. Nevertheless, that did not mean Estonia's currency board would last a decade. The staff and the authorities intended to monitor the situation constantly.

Mr. Dorrington commented that his Hong Kong authorities definitely did not regard the currency board as only a temporary solution. He asked whether, in the foreseeable future, reserves or the reserves that were net of the currency board requirements should be considered significant, if the currency board had complete reserve coverage.

The staff representative from the European II Department remarked that, with a currency board, regardless of the issue of its temporality, gross reserves should not be completely ignored. However, it would be difficult to determine the optimal level of reserves relative to imports. In any case, substantial coverage was needed as a contingency measure.

The Acting Chairman noted that the Hong Kong currency board had daily market operations to influence monetary conditions. A board that set monetary policy and maintained its structure was possible, but, for Estonia, it was preferable to keep its current currency board, which did not take an active role on a daily basis, in contrast to Hong Kong.

Mr. Havrylyshyn asked whether, by indicating earlier that two thirds of the industrial capacity had been privatized, the staff representative was referring to two thirds of state enterprises or the private sector as a whole, including fresh, private sector development.

The staff representative from the European II Department replied that he was including new private enterprises in his estimate. He regretted that he could not be more precise, but the staff did not have enough data.

Mr. Isataev made the following statement:

> Let me begin by congratulating the Estonian authorities on their outstanding accomplishments in transforming their economy. The radical, comprehensive program now under way is aimed at entrenching the gains of the reform program implemented during 1992/93, which included dramatically reducing inflation, continuing structural reforms, and reversing the downward trend of GDP growth. Estonia's exemplary achievements demonstrate more clearly than any other case the validity of the Fund's traditional prescriptions of radical liberalization, restrictive fiscal and monetary policies, and vigorous structural reforms for the countries of the former Soviet Union.
>
> The Estonian authorities are now well positioned to concentrate on safeguarding and consolidating the benefits of their radical reforms. Soon, increased flexibility of the labor

market, a strengthened banking sector, and the continuation of privatization should begin producing an adequate supply response: even though the program is only in its early stages, preliminary indicators foreshadow a strong recovery.

Measured against the persistent output loss in the rest of the countries of the former Soviet Union, Estonia's growth performance in the third and fourth quarters of 1993 is remarkable. As Estonia was among the countries hardest hit by terms of trade shocks and the disruption of trade in the countries of the former Soviet Union, this output performance would seem to cast doubt on the widely accepted notion that trade shocks were a major cause of the output decline of the countries of the former Soviet Union.

Estonia's success in rapidly reducing inflation is as striking as its output performance. It is very important to keep inflation low so as to preserve competitiveness and confidence in the domestic currency and provide favorable conditions for the growth of exports to Western markets, and the recent exchange-rate-driven increase in inflation therefore is worrisome. However, I share the staff's sound optimism about the future direction of the inflation curve. As stated in the report, Estonia's inflation differentials vis-à-vis its trading partners do not exceed the corresponding differentials in productivity growth, so there is still some room for maneuver.

I commend the authorities for their continued fiscal prudence. The 1994 budget is balanced and does not foresee any recourse to bank financing. Although the planned improvements in the efficiency of the tax system will increase revenues in the medium term, the staff warns that the short-term effects of the tax reform may be negative. As the results of measures for improving tax revenues are often lagged, it would be interesting to learn if the authorities have any contingency measures in this area.

Good progress has also been made since mid-1993 in strengthening the financial position of the commercial banks. Increased capital requirements, the introduction of new prudential regulations, decisive measures on bank recapitalization, and enactment of a bankruptcy law have decidedly improved the banking climate in Estonia and helped restore public confidence. The good news is that the commercial banks are expanding their credit to the private sector, and the maturity of their loan portfolios has begun to lengthen. Are there any signs that the commercial banks have begun repatriating the excess reserves they deposited abroad in recent years? It is reasonable to assume that repatriation will gain strength from the increasing attractiveness of Estonia's investment opportunities, which is also reflected in a significant increase in foreign direct investment over the last year.

Finally, a note on external policies. Export growth was enabled to become one of the forces driving Estonia's recovery by the authorities' policies of complete trade liberalization. The last trade barriers will fall when the remaining import tariffs are replaced with excise taxes. This will also eliminate the possibility of any discrimination between domestic and foreign producers. In this regard, I share the concern expressed by the U.S. Director that, unfortunately, the export obstacles erected by many industrial countries have become a standard feature of staff reports on transition countries, who may draw some comfort from the reflection that being forced to open their economies to external competition unilaterally also ensures that they will unilaterally enjoy the benefits of doing so, to the exclusion of their short-sighted Western trading partners.

The Estonian authorities' impressive record of policy implementation and the strength of the program fully justify the approval of the revised proposed decision. I wish the Estonian authorities every success in reforming their economy.

Mr. Havrylyshyn made the following statement:

The Estonian race toward a market oriented economy continued successfully in 1993, and the achievements in economic growth, inflation reduction, liberalization of exchange and trade regimes, and increased confidence in the national currency are impressive. The staff report makes a deep and convincing review of all these achievements which I fully endorse. Equally, the soundness of the program under way and the commitment of the authorities to continue their efforts in the period to come lead me to approve without hesitation the proposed decisions.

Against this background I have only two brief comments, the first on the issue of inflation and the second on the progress of the privatization process.

After the dramatic reduction of monthly inflation in 1993 to 2 1/2 percent from 24 percent in 1992, it is regrettable to see monthly inflation jump again to 5 percent in recent months, and the staff is right in stressing the risks that the continuation of such a tendency could involve. The main source of inflation identified in the staff report, rigidities of prices and wages, appears to be correct and the staff recommendation in this direction should be taken very seriously by the authorities. I would, however, like to hear staff views on the prospects that this aberrant jump is only temporary and inflation will indeed return to the earlier trend. In any event, like the staff, I am pleased to note the changes in the wage bargaining and in the unemployment compensation scheme, and I encourage the authorities to continue to improve the flexibility in the nontradable goods market. This is all the more important now that one external factor generating inflationary pressures, the real appreciation of the Russian ruble, is out of the authorities' control and its likely further influence should be offset by adequate domestic policies. Having said this, I fully understand the position of the staff and authorities that any effort at monetary activism to counter these inflationary pressures may undermine the credibility of the pure currency board system so far practiced and lead to the temptation of monetary activism in the opposite direction.

Regarding my second point, the staff appears not to be fully satisfied with the pace of privatization, and if one compares the progress in this field with that in macroeconomic stabilization, this is doubtless correct. While I certainly agree that Estonian authorities should make all efforts to proceed with privatization, I believe it is important--for Estonia as well as other transition economies--to put the issue in the broader context of private sector development. Unfortunately, the rather limited information on the subject in both the background paper on recent economic developments and the staff report makes a judgment on private sector development difficult. Nevertheless, some evidence seems to suggest more positive developments in the broader evolution of the private sector. Thus, credit to the private sector increased sharply in 1993--by 140 percent--while credit to state enterprises remained flat--Chart 3, page 4b. This phenomenon may give birth to a new term in the economic literature--i.e. "crowding in" of the private sector. Foreign direct investment saw a dramatic increase in the same period--from $58 million to $144 million, or 7 percent of GDP; 80 percent of service establishments and 92 percent of shops are in private hands while the share of services in GDP increased from 44 percent in 1992 to 56 percent in 1993. We find out from the background paper that unemployment did not become a social problem as was feared, partially because of the labor force being attracted into the emerging private sector which was not recorded by statistics. From the available data, if I am correct, this represents about 4 percent of the total labor force. Despite a slow pace of privatizing existing state enterprises, a parallel process has taken place--a large part of the labor force disemployed by the state sector has been employed by a rapidly growing private sector. All these indications, at least in comparison with most other economies in transition, seem to demonstrate a rather rapid progress in private sector development, if not actually in privatization narrowly defined. Could the staff comment on how big this new private sector may already be, and what effect it already has had in helping to impose a hard budget and subsequent efficiency improvements in the yet to be privatized enterprises?

Mr. Prasad made the following statement:

As one of the smallest republics to emerge from the former Soviet Union, the challenges for the Estonian authorities when they undertook the exercise of reinventing their Government in September 1991 would indeed have been formidable. By any yardstick, the program of the Estonian authorities for restructuring and stabilization can certainly be said to contain all the elements of success, and Mr. Bergo's statement confirms the resolve and determination of the authorities to stay on course. It is gratifying to see that the authorities have effectively met all quantitative performance criteria. The setbacks that took place were certainly not a result of any deficiency in the policy initiatives though slippages are always a concern, and even given the tentative nature of data, this is the right time to sound a note of warning on the inflationary trends. I would just like to touch on three points.

The steps to privatize large enterprises are a welcome development, given the general problems that other countries in the region have encountered in this regard, and the willingness of the authorities to invoke the bankruptcy option is also to be welcomed. I wonder if the staff would like to add a few comments on a related issue that has been referred to in the world economic outlook papers and could affect the pace of privatization--the experience with governance of privatized companies. Can we presume that this is not a major problem in Estonia to the same extent as the experience in some other countries, which has been that the workers and the management of the companies themselves have taken over the ownership and do not possess the skills or motivation to take the other hard decisions necessary to more effective performance?

On the functioning of the External Financing Board, I note from Appendix I of the staff report that the "Fund Resident Representative serves in an advisory role to the EFB." I wonder if I am missing the full picture and whether this is a normal practice. To the extent that the Fund has an advisory role to the authorities themselves, is this fine-tuning desirable? If the resident representative is associated with the specific decisions of the EFB, will this not complicate our overall role should developments be other than as desired?

Finally, I would like to look back into the future and draw attention to a typographical issue. There is a reference on page 37 in the same appendix to the Memorandum of Economic Policies dated October 6, 1994, on which date we should be deep into our Annual Meetings in Madrid.

With these remarks I support the proposed edited decisions.

Mr. Oya made the following statement:

I commend the Estonian authorities for their continued strenuous efforts in the transition to a market economy and their substantial progress in stabilizing the economy.

It is impressive that the authorities fully recognize what is required for successful economic reform and that they have implemented the necessary measures according to predefined priorities, in close consultation with the Fund. As the staff has continuously given useful advice in a wide range of areas, most of which I can support, I would like to limit my comments to just a few.

First, I wish to emphasize the importance of diversification of the direction of trade. According to the staff report, Estonia's export volume and prices in the markets of the former Soviet Union states rose rapidly since mid-1993 with the sharp real appreciation of the Russian ruble. The price of Estonia's imports from Russia has also risen. This trend partly accounts for the recent surge in inflation, which is casting a shadow on the prospects for Estonia's sustainable growth.

I am concerned that too much dependence on trade with a limited number of countries could have an adverse macroeconomic impact on Estonia, including inflation, caused by fluctuation of the exchange rate.

I urge the authorities to make additional efforts to diversify the direction of trade in order to attain stable economic growth. In this respect, I welcome the bilateral and multilateral free trade agreements that Estonia signed during the course of 1993. I believe these steps will pave the way toward diversification of trade.

Second, I would like to touch upon the importance of institutional and legislative actions for proceeding with structural reform.

Some of the structural reform measures, especially privatization and restitution, have a substantial social impact because they inevitably influence the rights and obligations of citizens. Any errors in the process could lead to social unrest which may jeopardize economic stability. In this light, the utmost importance should be attached to equal treatment and smooth procedures. Therefore, I believe that additional legislative measures aimed at the equitable resolution of all the complex issues are crucial. In addition, the authorities should establish institutions to deal with possible conflicts between citizens, and between citizens and the authorities, and train legal experts to work on the settlement of the conflicts.

Third, I would like to make some comments on tax reform. I agree with the main thrust of the tax reform measures incorporated in the 1994 budget. It is a particularly welcome development that the new personal income tax law contains provisions for tax withholding on wages, interest, and dividends. A similar system has been introduced in Japan, where it contributes a great deal to ensuring stable revenue and reducing the procedural burden on taxpayers. However, this system shifts the burden of filing from taxpayers to corporate accountants who are obliged to withhold tax on wages of their employees. Therefore, it might be helpful if the Government arranged for these accountants to be trained in order to achieve effective tax collection.

Finally, I agree with the staff that the recent upturn in inflation and the continued fragility of the banking system pose risks for further recovery and growth. However, the authorities have taken various corrective measures that should begin to work in the near future. I would just like to urge the authorities to maintain the momentum of economic reform.

With these remarks, I support the proposed decision.

Mr. Mancebo made the following statement:

At the outset let me express my broad agreement with the thrust of the staff appraisal. However, I would like to highlight some aspects that I believe deserve special consideration.

The authorities have been successful in rapidly reducing inflation. The upturn since September 1993, if allowed to persist, could nonetheless give rise to new concerns about the sustainability of the stabilization effort. The increase in the price of some services and of Estonian exports, and the supply rigidities in the nontradables sector associated with the pickup, are the main factors that explain the inflation upturn. The maintenance of prudent financial policies and strict adherence to the currency board arrangement should allow for a continued lowering of inflation.

The solvency of the banking system constitutes another area of concern. After the crisis of approximately one year ago, the situation still remains problematic for a number of banks. In this regard, I agree with the staff that the authorities should resist pressures to permanently assist banks in financial difficulty owing to nonperforming loans. At the same time, the prompt enactment of the Credit Institutions Act, and further strengthening of bank supervision and prudential requirements, are considered essential to re-establish confidence in the banking system and foster a more efficient intermediation, which is considered crucial for the transformation process.

We appreciate the fact that there has been a substantial buildup of international reserves and that, at present, gross reserves comfortably cover the currency board requirement. In this context it is appropriate to consider, in assessing the strength of the balance of payments, that the Estonian economy has recently emerged from a process of full-fledged hyperinflation that has left a very weak financial system and a climate of fragile confidence at this early stage of structural transformation. Thus the concept of gross international reserves should not be applied mechanically. A more judgmental assessment of the overall strength of balance of payments prospects factoring in the requirements of the exchange arrangement, which in the case of currency board limit the usability of the liquid reserves, is in my view clearly needed.

In the structural reform area, noninterference by the Government in the wage determination process, as well as measures aimed at fostering employment through adequate training programs, is deemed necessary. The authorities should also be encouraged to persevere in their efforts to generate momentum for the privatization of large enterprises, which has recently slowed down, so as to reap the benefits that have already been achieved with the privatization of smaller enterprises.

The Estonian authorities have demonstrated courage and skill in achieving their goals in many areas, despite the external uncertainties. I remain confident that they will be equally successful in the adjustment and reform effort in the future.

In closing, I support the proposed decisions pertaining to the 1994 Article IV consultation and review under the stand-by arrangement and wish the authorities well.

Mr. Link made the following statement:

Like other Directors, I would like to commend the Estonian authorities for the promising implementation of their reform program. Estonia's track record in stabilizing its economy has been impressive so far.

As all quantitative criteria for end-December 1993 have been observed by the Republic of Estonia, this chair supports the proposed decision on the completion of the first review under the stand-by arrangement.

In the report, the staff attributes the recent rise in inflation to the undervaluation of the kroon vis-à-vis the deutsche mark, the recent real appreciation of the Russian ruble, and the recent rapid growth of real incomes combined with relatively inelastic supplies in the nontradable sector. At the same time, according to a paper written by Bank of Estonia economists, and distributed at a recent meeting of the EFTA Economic Committee and Baltic officials, the most important factor contributing to high inflation is the opening of the economy to world markets while the exchange rate remains fixed. As productivity of the economy increases and a remarkable amount of foreign currency, either in the form of loans or direct investments, flows into the economy, Estonia's balance of payments remains in surplus. Because of the currency board arrangement, the nominal exchange rate remains unchanged and increased reserves lead to excessive monetary growth, hence inflation.

Let us consider for a moment what has happened in Latvia, where inflows of foreign currency met with a flexible exchange rate. In Latvia, the currency initially appreciated in nominal terms, thus permitting price stability to be maintained while sacrificing competitiveness. At the same point, the Bank of Latvia decided that the currency had appreciated enough, and began buying the foreign currency. This resulted in higher inflation, which was criticized by the staff as a failure to respect performance criteria. Could the staff comment a little more on that issue?

With these remarks, I wish the authorities the best.

The staff representative from the European II Department, in reply to Mr. Blome's suggestion that the flat tax be replaced with a more progressive one, considered that the flat tax provided a simple structure for economic agents, and, in present circumstances, the staff did not wish to make rapid changes that would introduce instability to the tax structure.

The Tartu Commercial Bank had been liquidated and some of its branches had been sold to other commercial banks, the staff representative remarked. Unlike other countries of the former Soviet Union, Estonia had actually liquidated banks, and its bankruptcy law, which applied not only to banks but also to other enterprises, appeared to be functioning reasonably well. In the staff's view, those measures had been vital in making the budget constraints effective.

The administrative tax of 1/2 of 1 percent on imports and exports was designed simply to cover the administrative costs associated with customs, and applied to both imports and exports, the staff representative continued. According to the latest information, the authorities were considering replacing these two taxes with a 1 percent tax on imports only.

The staff believed that the share of tax revenues to GDP would fall in 1994 because direct income tax rates would be lower, the staff representative noted. Collection of the value-added tax would not grow as rapidly as GDP because collection for the emerging private sector was not yet effective, and spending on investment goods--which were exempt from the value-added tax--was expected to grow at a much faster pace than GDP in 1994.

Although there had been a number of director buyouts in the privatization process, few worker buyouts had taken place, the staff representative added. The staff was not aware of any complaints that funds had been mishandled or that operations had not been transparent. It appeared that privatization in Estonia was proceeding relatively smoothly. The market was functioning fairly honestly and transparently owing to the openness of the economy and the tremendous inflow of funds for foreign direct investment and joint ventures.

A small amount of bank reserves had been repatriated from abroad, but that was not a major trend, the staff representative said. Currently, by holding their excess funds abroad, commercial banks found that they had a much wider scope of instruments for investment. Over time, that tendency would diminish.

If tax receipts fell substantially below the amount forecast, as a result of the decline in the corporate income tax rate and the statutory rate for households, the authorities did not have any contingency measures on hand, the staff representative noted. However, in the past, the authorities had shown their commitment to their budget goals whenever revenues fell relative to expenditures. For example, they had introduced a land tax in 1993, excise taxes on alcohol in February 1994, and a fuel tax. Thus, they had shown a great deal of flexibility in responding to perceived shortfalls in revenues.

As the External Financing Board developed and became operational, the staff hoped that the Fund would play a diminishing role, the staff representative from the European II Department remarked. Currently, a Fund advisor was providing technical assistance in setting up the Board. The Board, with the tranching of credit lines, was designed to be as noninterventionist as possible and still adhere to the Government's goal to lend funds to the commercial banks in a responsible way.

Mr. Bergo remarked that his authorities were aware that Estonia was only a success story in a relative sense, and that the challenges remaining were still of a considerable magnitude. They agreed with Directors in stressing the importance of containing inflationary pressures. However, they shared the staff's view that, at present, a change in the stance of monetary or fiscal policy was not advisable. In the monetary and fiscal area, developments should be kept under close supervision, and his authorities were prepared to act should inflationary developments be on the verge of getting out of hand.

Several Directors had questioned the length of time that the currency board would be in place, Mr. Bergo continued. His authorities did not plan to change the current arrangement, nor had they made plans for a successor arrangement. That position indicated that, although Estonia had made important advances, its transition was still not complete. Only on completion of the transition would a choice be available on a foreign exchange regime--at that time, the choice could well be a continuation of the present arrangement. In addition, his authorities regarded exchange rate stability as paramount to the credibility of the currency board arrangement.

With respect to future arrangements between Estonia and the Fund, the appropriateness of various types of arrangements would have to be reviewed in light of developments during the program period, Mr. Bergo added. His authorities certainly would value cooperation with the Fund within the formal framework of an arrangement, and they aimed at having such an arrangement in place in 1995.

As several Directors had expressed concern about the Bank of Estonia's financing of commercial banks that were in difficulty, Mr. Bergo noted that the central bank's involvement in the recapitalization of the North Estonian Bank was a one-time measure without precedents. Furthermore, that operation should be judged taking into account the fact that the North Estonian Bank's nonperforming loans had been inherited from the former central bank, which made the new central bank morally, if not legally, responsible. In the authorities's view, the operation was a political necessity. In that connection, the central bank would not absorb future losses of commercial banks, nor would it acquire new claims on commercial banks other than in emergency situations.

The Acting Chairman made the following summing up:

Executive Directors welcomed the continued implementation of Estonia's economic stabilization and reform program--representing an extension of the macroeconomic policies and a deepening of the reforms adopted almost two years ago--and the fact that all performance criteria had been met. They commended the results of these policies, including the rapid decline of inflation since the establishment of the currency board, the expansion of trade with industrial countries, the commencement of output recovery--after one of the shortest turnaround periods in comparison with other economies in transition--and the virtual full convertibility of the kroon in current as well as capital account transactions.

While inflation had come down significantly since the currency reform in mid-1992, Directors expressed concern about the large price increases in recent months. Currently, inflation was influenced by transitory factors associated with the exchange rate, supply-side rigidities in the nontradable sector, and the further elimination of implicit subsidies through increases in administered prices. Directors stressed, however, that unless inflation declined in coming months as the effects of some of the special factors began to dissipate, there would be a danger that excessive wage pressures would develop. If wage increases outran productivity growth in the traded goods sector, the real exchange rate could appreciate strongly. While the currency board arrangement would help bring about an automatic correction of that problem, the adjustment cost in terms of short-run losses in output and employment could be high. Directors agreed that the appropriate policy response would be to enhance supply-side policies in order to improve the flexibility of prices and wages and the efficiency with which labor and capital were utilized. Directors also stressed the importance of maintaining a firm stance on fiscal policy and called for a strengthening of tax administration and continued effective control on expenditures.

Several Directors noted that confidence in the banking system remained fragile despite the successful bank rescue operation a year ago and the adoption by the Bank of Estonia of new prudential standards and provisioning for nonperforming loans. Directors stressed that it would be important to strengthen bank supervision further. Directors also noted the wide spread between borrowing and lending rates. They also emphasized that, with a view to preserving the integrity of the currency board, the financial resources of the Bank of Estonia should not be involved in the future in the recapitalization of the banking system.

With respect to structural policies, Directors praised Estonia's achievements in liberalizing trade and capital movements. They believed that the virtual full convertibility of the kroon in current and capital account transactions had contributed strongly to making the price mechanism the foundation of resource allocation and the incentive structure. In that connection, Directors welcomed the Government's intention to accept the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement.

While Directors were disappointed by the slow progress made in large-scale privatization, they were encouraged by the progress made in the privatization of smaller enterprises. Directors viewed more rapid progress in structural reforms as necessary to preserve the gains from stabilization and to move the Estonian economy to a new stage of low inflation combined with strong and sustainable growth.

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

The Executive Board took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1994 Article XIV consultation with the Republic of Estonia, in the light of the 1994 Article IV consultation with the Republic of Estonia conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Republic of Estonia's restrictions on payments and transfers for current international transactions are maintained under the transitional arrangements of Article XIV, Section 2, as described in EBS/94/61. The Fund encourages the Republic of Estonia to eliminate these restrictions as soon as circumstances permit.

Decision No. 10642-(94/32), adopted
April 8, 1994

Review Under Stand-By Arrangement

1. The Republic of Estonia has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for the Republic of Estonia (EBS/93/166, Sup. 2, 11/2/93) and the last paragraph of the letter of the Prime Minister and the Governor of the Bank of Estonia dated October 6, 1993.

2. The letter of the Prime Minister and the Governor of the Bank of Estonia dated March 11, 1994 shall be attached to the stand-by arrangement, and the letter dated October 6, 1993, with annexed memorandum, shall be read as supplemented and modified by the letter dated March 11, 1994.

3. Accordingly,

(a) Paragraph 3(a) of the stand-by arrangement shall be amended by adding as paragraph 3(a)(viii) "the limit on the domestic financing of the general government's financial deficit and net lending described in Annex I of the letter dated March 11, 1994,".

(b) The performance criteria set out in paragraph 3(a)(i) and 3(a)(ii) of the stand-by arrangement for March 31, 1994, June 30, 1994, and September 30, 1994 shall be as specified in Annex I of the letter dated March 11, 1994.

(c) The performance criteria set out in paragraphs 3(a)(iii) through 3(a)(vii) of the stand-by arrangement for June 30, 1994 and September 30, 1994 shall be as specified in Annexes II through IV of the letter dated March 11, 1994.

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

Decision No. 10643-(94/32), adopted
April 8, 1994

4. REPUBLIC OF LITHUANIA - 1994 ARTICLE IV CONSULTATION; REVIEW UNDER STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered the staff report for the 1994 Article IV consultation with the Republic of Lithuania, the first review under the 17-month stand-by arrangement for Lithuania approved on October 22, 1993, and the Republic of Lithuania's request for a second purchase under the systemic transformation facility in an amount equivalent to SDR 25.875 million (EBS/94/60, 3/23/94; Sup. 1, 4/5/94; and Sup. 2, 4/7/94). They also had before them a background paper on recent economic developments in the Republic of Lithuania (SM/94/82, 3/29/94; and Cor. 1, 3/30/94).

Mr. Bergo made the following statement:

The excellent staff papers set out very clearly the Lithuanian authorities' policy objectives, the achievements in the program's implementation and their strategy over the next year. My authorities very much appreciate the extremely valuable assessments and advice contained in the papers, as well as the frank and open discussions that have preceded them, and, not least, the technical assistance provided by the Fund staff in preparing for and implementing the new monetary arrangements.

The Litas Stability Law, which was passed by Parliament on March 17, 1994 and signed into effect by the President on March 22, 1994, and the subsequent implementation of a currency board arrangement, operative as of April 1, 1994, marks a major change in Lithuania's monetary and exchange arrangements. It also marks the end of a protracted period of discussion and debate as to the most appropriate policies and institutional framework for Lithuania to foster macroeconomic stabilization and a noninflationary growth environment. Given the importance and far-reaching consequences of the matter, it was necessary to allow for a thorough debate within the various institutions involved, between the institutions and among the general public, and to follow the normal procedures for the legislative process. This has helped forge a broad support for the measures, and has ensured that all parties involved, now that the decision has been taken, are wholeheartedly working to make the arrangement an operational success.

The conscientious and thoroughly prepared introduction of the currency board has occupied much of the authorities' attention in recent months. It is understandable, if regrettable, that during this period other matters, also important, have been delayed somewhat. In addition, some uncertainty may have existed as to the future monetary and exchange system, even if monetary policy remained tight prior to the implementation of the currency board. This uncertainty should now have been removed, and my authorities are firmly committed to establishing and maintaining the integrity of the currency board. Aside from that, my authorities now intend to concentrate on the other priority areas. They recognize that a number of important challenges lie ahead, and most urgent are the intensification of the structural reforms, especially privatization; further reform of the tariff and tax systems; and financial sector reform.

Before I turn to the assessment of the progress made since the last review in these and other areas, and the authorities' future agenda, let me make a few more comments on the currency board, especially the choice of anchor currency and the setting of the exchange rate. The choice of the U.S. dollar as the currency to which to fix the litas is hardly controversial. Given the importance of the dollar to the Lithuanian external sector, almost all foreign exchange transactions and currency deposits being denominated in the dollar, and its being the major reference currency in the foreign exchange market, this was a very natural decision. With regard to the exchange rate, the staff has argued that a slightly more appreciated exchange rate might have been more appropriate. However, given the speculation that took place against the litas prior to the implementation of the currency board, where substantial interventions were necessary to stabilize the rate at Llt 4 per dollar--down from a level of approximately Llt 3.90 per dollar--my authorities felt that it could weaken the credibility, and put unnecessary strain on the arrangement at the outset, if a rate more appreciated than the present market rate were chosen. In the view of the authorities, the chosen rate would not compromise past inflation gains, but would safeguard the arrangement, as it would allow for some resources for emergency lending to the banking system, where fragility is recognized, in addition to providing full currency board coverage.

The change in the monetary and foreign exchange system necessitates making certain modifications and supplements to the stand-by arrangement with the Fund, and my authorities hope the

Board would be agreeable to the request as set forward in the letters from my authorities to the Managing Director.

Five months have now passed since the Executive Board approved Lithuania's second stand-by arrangement and the request for purchase under the systemic transformation facility. Despite somewhat uneven progress in the area of structural reform, the program is on track, with all but one of the performance criteria for the fourth quarter of 1993 having been met; and it is expected that the last one, net lending by the Government, will be met by a comfortable margin at the end of March.

The vigor of adjustment has been manifested in many areas and there are signs of economic recovery. The downward trend in the economy was already slowed down in 1993 and, taking into account the rapidly growing private sector, the coverage of which is less than adequate in the official statistics, cautious optimism that recovery is underway seems warranted. This, together with the continued strong commitment of my Lithuanian authorities to sound macroeconomic policies and market-oriented reforms, constitutes the basis for the expected GDP growth of close to 5 percent annually for the rest of the decade.

With regard to monetary and foreign exchange policy, the move to the currency board arrangement should greatly facilitate financial stability, contain inflationary pressures and lower interest rates, and help to exercise fiscal discipline. The full convertibility of the litas certainly brings the acceptance of Article VIII status very much closer.

The authorities' strong commitment to fiscal discipline has been very well demonstrated by the implementation of the budgets since Lithuania regained independence and will be continued, as this is seen as absolutely essential in making further progress in the key area of bringing down inflation.

The progress has been uneven in the area of structural reform. Some delays have been almost unavoidable, given the matter's close interdependence with the question of the choice of monetary regime. In other areas, unsatisfactory progress must be attributed more to deficiencies in administrative capacity and routines. However, in other areas, again, progress has been quite remarkable.

At the Board discussion in October, though Directors were generally supportive of the program and generous in their praise of the achievements, a number of concerns with regard to structural reforms were aired. I should like to address, with the benefit of five months' hindsight, some of these concerns.

Most Directors then expressed concerns about the situation in the financial sector. Here, new legislation was delayed for several months pending the outcome of the currency board debate. However, this is now being given the highest priority. A draft central bank law approved by Government and submitted to Parliament is currently being reviewed in light of the currency board. A draft commercial banking law is very close to completion. Options to reduce government ownership in the three state banks to around 20 percent--voting control already having passed into private hands--are actively being studied, as are options for dealing with banks failing to meet the new minimum capital requirements. It is expected, however, that they will be closed down or merged as soon as legislation enabling this is in place. The Bank of Lithuania has sharply strengthened the enforcement of its prudential standards, and won acceptance from the Supreme Court for applying sanctions to nonconforming banks. Reporting systems for banks have been improved and work is under way on new plans of accounts.

The privatization process, which was already further advanced in Lithuania than in most other transition economies, has continued steadfastly, if not very speedily, since October. Efforts are now being made to accelerate the process, in the privatization of both land and enterprises. The problem of interenterprise arrears, an area of concern in the October discussion, has been reduced, a bankruptcy law is in force, and a number of enterprises have gone into bankruptcy or are pending.

The need for further reform of the tax and tariff system was underlined by several Directors in October. After some slippage in the timetable, significant progress has now been made in rationalizing the tariff structure. Further reductions in import tariffs are expected when the value-added tax comes into effect on May 1, 1994, itself a major step forward in streamlining the tax system. Remaining export tariffs will be eliminated by the end of 1994.

In October, several Directors were concerned about the authorities' intention of playing a more active role in the disbursement of EU/G-24 (Group of Twenty-Four industrial countries) loans. Though my authorities maintain that, at the time, there was really no alternative, it must be admitted that developments in this area were less than satisfactory. Weak administrative routines and unsatisfactory systems of reporting and monitoring led to net government lending exceeding the performance criterion for the fourth quarter. The authorities have moved forcefully to rectify this. A larger share of foreign assistance will now be channeled through the banks. The operating procedures of the State Liability Commission are being strengthened and tighter controls introduced on the volume of lending and of repayments. As the staff points out, these measures already seem to have shown some success, and the end-March criterion should be met by a comfortable margin.

Finally, let me reiterate my Lithuanian authorities' deep appreciation of the enormous contribution of the Fund staff to the reform process in Lithuania and, most recently, to the introduction of the currency board. They look forward to continuing the excellent dialogue and cooperation in the years ahead, and intend to move to an arrangement under the extended Fund facility in the near future.

The staff representative from the European II Department noted that the currency board had been functioning smoothly in its first week of operation. During that period, the Bank of Lithuania had purchased $4 million from commercial banks. While the currency board law in Parliament was in its third reading in mid-March 1994, Parliament decided to confer the power to make exchange rate changes on the Government and the Bank of Lithuania. A great deal of foreign exchange speculation had occurred between the time the currency board law was passed and when it was put into effect, which proved that that power in Parliament's hands could have been disastrous. The Government was firmly committed to the arrangement and was responsible for introducing it to Parliament.

The authorities were proud of their success in reducing the rate of inflation, which in March 1994 was at 3.3 percent, the staff representative continued.

Mr. Dorrington made the following statement:

The authorities' recent decision to introduce a currency board is certainly not an easy option. It ups the stakes: it increases both the upside and downside potential. It is a sign of my optimism that I welcome the decision. It should promote a stable and predictable macroeconomic environment to foster recovery in 1994, consolidate recent progress in lowering inflation, and reinforce existing fiscal rectitude. In general, it should provide a boost to the credibility of the Government's commitment to reform.

However, there is a risk that the credibility benefits of the new system may be threatened by fears of future devaluation, given the potential threat to external competitiveness from high wage growth, and political pressure from domestic exporters. Particularly given the internal debate over the wisdom of a currency board, and the relative--and I stress relative--lack of external confidence in Lithuania in comparison with the other Baltic countries, as demonstrated by the relative lack of foreign direct investment, it is essential that everything possible be done to reinforce the credibility of the currency board, particularly during its early life. I share the staff's assessment that the flexibility--if that is the right word--or the decision as to how to contain the flexibility in changing the rate does, I think, work in that direction. To abandon the peg would be far worse than not having had a currency board in the first place. Another risk is of real appreciation leading to protectionist pressures.

There is certainly a potential conflict between Lithuania's need to maintain export competitiveness and the real wage growth expected to accompany the economic recovery. In order to minimize inflationary pressure from this wage growth, the authorities must recognize the need for corresponding productivity growth, signs of which have not been clearly evident. Accelerating structural reform is therefore vital, but early progress in privatization has recently stalled, while industrial and financial restructuring remain minimal.

A necessary condition for success of the currency board is a balanced budget. I certainly welcome the authorities' plans to maintain tight expenditure control and consolidate revenues in 1994. I also agree that particular attention needs to be paid to streamlining the benefits system, consistent with fiscal discipline. The low projected budget deficit in 1994 may be jeopardized by the relatively high official poverty line, and by wage claims in the state sector. And as in Estonia, the authorities need to press ahead with developing instruments for nonmonetary deficit financing, to meet potential budgetary pressures. I wonder whether Lithuania may benefit from any lessons learned from Latvia's recent introduction of government debt instruments.

I have one question, which derives from Mr. Bergo's statement. He describes the choice of the U.S. dollar as the reference currency for the currency board as hardly controversial. Presumably by implication he would regard Estonia's choice of the deutsche mark as controversial. I recognize the arguments he puts, but I would have thought that the fact that the large part of Lithuania's trade is with countries whose currencies move more in line with the deutsche mark or the ECU, than the dollar, was a more important consideration. In any event, the decision has been taken, and the priority now is to stick with it.

I welcome the authorities' intention to improve intermediation of foreign financial assistance, given that the investment component of demand-led growth relies on the efficient and productive disbursement of these funds. But there is a parallel need to develop commercial channels of intermediation through accelerating bank restructuring. This was debated at some length at the last discussion, but it is a point worth reinforcing.

The establishment of the currency board makes bank restructuring that much more urgent, given that it largely removes the lender-of-last-resort function of the central bank. A continued weak banking system could threaten the currency board: thus, development of effective banking supervision by the Bank of Lithuania should be a high priority.

Mrs. Wagenhoefer made the following statement:

I welcome the fact that we are discussing today two of the Baltic States. Estonia and Lithuania have quite a few features in common--such as their relative size, their geographical situation on the eastern shore of the Baltic sea, and their heritage of heavy industrialization starting 40-50 years ago, with the consequence that by 1987 a very large share of their total trade was transacted with the other parts of the former Soviet Union: 87 percent in the case of Estonia and 88 percent in the case of Lithuania.

Upon becoming independent states and soon after--or even before--application for membership in the Fund, the Estonian and the Lithuanian Governments embarked on policies to transform their economies in close cooperation with and financial support from the Fund. Over the past three years--from 1991 to 1993--the Lithuanian authorities appear to have followed a somewhat more restrictive fiscal policy line, whereas in other macroeconomic aggregates the country so far seems to have made less conspicuous progress. It would be challenging to analyze the reasons for this--but this is a task that I would rather leave to the staff, which, incidentally, embarked on such an analysis last fall.

I agree with the main thrust of the staff report. The authorities are to be commended, in particular, that the program initiated in October 1993 is--with one exception--on track. I would also emphasize Mr. Bergo's comment in his statement regarding the authorities' successful implementation of fiscal discipline ever since the country regained independence. The introduction of the value-added tax on May 1, 1994 will--as the staff rightly points out--further strengthen the fiscal position--albeit with the usual time lag. Finally, I welcome the authorities' latest measures to further liberalize the trade regime, thereby showing again their strong commitment to a strategy of outward-oriented development.

This being said, the authorities seem to be well aware that much needs to be done. I would like to focus on two areas, namely one where I would warn against being too enthusiastic, i.e. the currency board, and the other the important structural challenges that need to be tackled urgently.

The Lithuanian authorities are to be commended for introducing a currency board arrangement which--as I understand the staff--was modeled on the Estonian one. Given the obvious success of the Estonian arrangements, there is ground for hope that this fundamental change in Lithuania's monetary and exchange regime may provide the necessary credibility for a fixed exchange rate regime and that it may impose an added measure of fiscal discipline, thereby contributing to lower rates of inflation and to lower interest rates. As there seem to have been longer discussions about the right dollar/litas rate to be set, I welcome the staff's information about very positive developments since April 1 when the rate was fixed. Let me add that this chair, too, would be curious to know more about the reasons for choosing the U.S. dollar as opposed to a European currency.

However, let me issue a warning along the lines referred to by this chair this morning during the discussion of Estonia. As regards the option of a more interventionist monetary policy to combat inflation, the staff pointed out--in the case of Estonia--that this was neither necessary nor advisable because of the self-correcting mechanism built into the currency board regime. However, this self-correcting mechanism works only with a considerable time lag, which means that monetary expansion is only reversed after the existing demand pressures have led to a current account deficit and a subsequent decline in reserves. Moreover, it is also possible that the self-correcting mechanism fails altogether, for example in the case when a growing current account deficit is accompanied by even higher capital inflows, which lead to increasing reserves.

To sum up, the authorities should closely watch the developments of monetary indicators--including the growth of broad money and the interest rates--with a view to eventually strengthening monetary policy if need arises.

I fully support the staff's recommendations regarding the specific areas that now should be urgently addressed. May I add that I have some sympathy with Mr. Bergo's comment that the "introduction of the currency board has occupied much of the authorities' attention in recent months" and that during this period other matters have been delayed. However, I remember that in the Board's discussion on October 18, 1993, this chair "reiterated" the need for establishing a workable and efficient financial sector and that indeed most Directors at that time expressed concerns about the situation in the financial sector. I, therefore, welcome the staff's rather strong language relating to the weak banking system and to the slowness in acting on technical assistance advice.

As far as privatization and enterprise reform are concerned, I again agree with the staff's recommendations for prompt and speedy action. According to further information provided by certain studies, the principle of "national treatment" of foreign investors does not appear to be followed--at least as far as the bidding of enterprises to be privatized is concerned. Perhaps the staff would respond. Furthermore, the whole process of privatization seems to be hampered by insufficient knowledge about which enterprises are to be privatized. Do the Lithuanian authorities envisage establishing something like a central "privatization administration" to handle the whole process or do they contemplate setting up a schedule for privatization?

With these remarks, I can support the proposed decisions, as amended.

Mr. Ryan made the following statement:

Lithuania's decision to establish a currency board reflects well on the authorities' policy priorities. It sends a clear signal that stabilization is a pre-eminent concern, and that the Government is willing to sacrifice discretion over policy instruments in achieving a sound currency. Additionally, a currency board should catalyze and reinforce other virtuous policy tendencies, including fiscal restraint, more prudent banking practices, privatization, and reduced supply-side rigidities.

Obviously, these goals, including price stability, can be achieved in other ways. However, we are sympathetic to the concerns of the authorities to better insulate monetary policy from outside pressure. The simple fact that there have been four central bank governors in the last year suggests a problem.

The choice of the dollar as the anchor currency is probably a source of pride to my monetary authorities, but, like others, we would appreciate some elaboration of the factors mitigating against a choice of a European anchor--particularly given that Estonia's trade and business relations can be expected to become increasingly integrated with Europe. I would emphasize that I raise this issue as a question, not a criticism of the authorities' choice. Also, what impact might the different anchors in Estonia and Lithuania have on Baltic economic relations/integration?

Also, given the apparent undervalued rate of exchange to the dollar, one might expect upward price movements as domestic prices adjust to international levels. Relatively faster increases in productivity, particularly in the tradable sector, could reinforce this real appreciation. We would be interested in the staff's comment on this issue.

We would also appreciate some elaboration by the staff on the role of Fund financing in the currency board context. It appears to serve a sort of stabilization role. On page 13 of the staff paper, however, there is a reference in a footnote to blocked accounts in commercial banks, but the relationship to Fund drawings is a bit unclear.

Now that the currency board has been chosen, of course, authorities will need to pay increased attention to other policy objectives. Fiscal restraint is essential to maintaining confidence in the integrity of the currency board, particularly given the still fragile state of the banking system. In this respect, the Government's record of fiscal balance is a good one. We wonder, however, if the planned deviation from this trend to financial imbalances requiring domestic financing over the medium term is prudent.

We recognize that the 1994 financial deficit is modest, but wonder if the banking sector's fragility might exacerbate the crowding out that might ensue as a result of recourse to domestic financing--e.g., banks sopping up treasury bills and being more parsimonious with loans to the private sector.

Moreover, there is the question as to whether more might be done to shore up the budget in certain areas. Revenue performance, in particular, has been disappointing. The background paper on recent economic developments discusses various reasons for the decline in revenue by some 7 percent of GDP last year, but does not give a lot of confidence that the situation will turn around anytime soon. Tax compliance, in particular, must be improved. Administrative weaknesses take time to remedy, of course, so efforts ought to be focused on getting the biggest bang for the buck in the short term, i.e., emphasizing those areas where taxes are more easily collected. The implementation of the value-added tax will be a step in the right direction in this regard.

On the spending side, increased efforts ought to be devoted to developing a Treasury in order to improve information and control over expenditures. In addition, the staff present a compelling case for re-examining the fiscal implications of various reforms to the social safety net, including the pension and welfare systems.

Again, the deficit in 1994 appears modest. Moreover, one might expect national savings to pick up as growth recovers and enterprise profits increase, thus helping to accommodate government borrowing needs. Still, given the negative net international reserve position of the bank, vigilance on the fiscal side gains added importance in order to ensure confidence in the integrity of the currency board.

Establishment of the currency board increases the need for measures to strengthen the banking system. The staff notes some progress in this regard but also emphasizes the need for additional measures. Reference is made to needed banking legislation that was held up pending adoption of the currency board. Mr. Bergo's statement describes this legislation, designed to strengthen bank regulation and supervision, as being of the highest priority. What sort of time frame on enactment is expected?

The decision to channel more EC/G-24 funds through the banking system is encouraging in principle; government intermediation is something one hopes to see diminish in favor of commercial allocation of resources. At the same time, such funds can be expected to reduce capital ratios at commercial banks from levels that could already use a boost. There is probably no easy answer to this dilemma, except to stress the need to continue strengthening the banking system.

It should go without saying, of course, that any funding from the currency board reserve fund must be strictly limited to emergency liquidity situations. To the extent that supervisory discipline remains somewhat inadequate, market discipline should not be diluted by bailouts. To the extent recapitalizations are necessary, recourse should be through the budget.

Reasonable progress has been made in privatization, but more needs to be done. The enhanced need for sound fiscal policy gives added impetus to accelerating privatization efforts in order to reduce enterprise calls on government-subsidized credits. We strongly concur with the staff on the benefits of quickly passing legislation lifting restrictions on shareholding by outsiders, including foreign investors who could be expected to respond particularly favorably in light of the establishment of the currency board.

In sum, Lithuania has taken a big step with the currency board that should stimulate many other forward steps in developing an open, market economy. We would encourage the authorities to show similar fortitude in moving in other areas, in order to reinforce the currency board and build on the confidence it can be expected to engender among domestic and foreign investors.

Mr. Desruelle made the following statement:

The most promising element in the reports in front of us is the signs of recovery. Thus, the efforts of the authorities, demonstrated for instance by the strong fiscal stance that they have maintained, seem poised to pay off in terms of renewed growth. Some success has also been achieved as regards inflation but, there, progress has not been as fast as expected.

In this context, the adoption of a currency board arrangement, which is, in some sense, the choice of rules over discretion in macroeconomic policymaking, is welcome, as it strengthens the authorities' commitment to stabilization. I understand that there exists a consensus on the main ingredients for a successful currency board, and these are the choice of the anchor currency, the commitment to a tight fiscal stance, and a sound financial system.

On the first element, one would ideally like a peg to a stable anchor as well as a peg that precisely reflects the country's trading pattern. Obviously, for Lithuania, such a peg does not exist, and a pragmatic choice had to be made. Without wishing to diminish in any way the legitimate pride of Mr. Ryan's authorities, I, like previous speakers, would have found quite natural the choice of the deutsche mark or the ECU, given the relative importance of trade with Western Europe. In any case, now that the decision has been taken, I agree with Mr. Dorrington that what presently matters is to make the chosen peg stick.

On the second element--commitment to a tight fiscal stance--the authorities have repeatedly shown over the recent past that they can deliver a fiscal stance that yields a positive financial balance and an overall deficit that can be entirely foreign financed. Nevertheless, the staff identifies certain potential pressures on this year's budget, such as calls for higher public sector salaries, difficulties with the implementation of the value-added tax and reforms of social benefits. It will thus be essential to remain extremely vigilant on the fiscal front. Any unexpected increase in expenditures or shortfall in revenues would have to be fully compensated for by increased efforts on both expenditure and revenue.

On the third element--soundness of the financial system, we are clearly on much weaker ground. As Mr. Bergo stated, the fragility of the banking system is recognized. Because, under a currency board arrangement, the central bank is not in a capacity to be a lender of last resort--it cannot exchange domestic currency for domestic assets--this is a matter of some concern. In this respect, I would welcome the staff's answers to the following questions: is there an expectation that bank rescue operations could exceed the $10 million of the emergency lending facility--provided out of the central bank's excess reserves? And, if so, have allowances been made in the Government's budget for such operations?

Beyond this specific issue of allowance for rescue operations, it is clear that the introduction of the currency board arrangement has made the reform of the financial sector even more essential than before. It is welcome news that, to quote Mr. Bergo again, this is now being given the highest priority.

Regarding the actual operation of the currency board, I feel somewhat uncertain as to its impact on inflation in the present context, as I note some similarities with Estonia's recent situation. In particular, I note, from Table 7 of the staff report, that the overall balance of payments is expected to be significantly positive in 1994, which should translate into a large increase in broad money. Could the staff elaborate on its projections for inflation in 1994 in these circumstances?

On other reforms, let me simply mention the reform of the trade regime. Trade liberalization is a natural complement to the currency board arrangement, as both are designed to facilitate the integration of the Lithuanian economy in the world economy and to boost the confidence and interest of foreign investors. Therefore, while it may be regretted that the timetable for trade reform was allowed to slip in late 1993, the authorities should be commended for the trade liberalization measures taken this year. The authorities are also urged to proceed, as intended, with the elimination of export tariffs this year.

In conclusion, let me repeat that I welcome the introduction of the currency board arrangement and the commitment to macroeconomic stabilization that it represents.

Responding to those who had questioned why the dollar had been selected as an anchor currency, the staff representative from the European II Department remarked that the issue had been discussed extensively with the authorities, and they had decided to make that choice. In any case, between 80 and 90 percent of foreign exchange transactions in Lithuania were in dollars, and nearly all its trade with its eastern neighbors was in dollars. In the future, although it was likely that trade would increase with Western Europe, the staff had advised the authorities that the most important issue was not future trade, but choosing an exchange rate anchor and adhering to that choice.

With respect to Mrs. Wagenhoefer's reference to the time lags involved in applying the currency board's self-correcting mechanism, Lithuania had started well, and inflation had been brought down, the staff representative continued. However, further administrative price adjustments were expected, the value-added tax would be effective in May 1994, and, later in the year, further increases in electricity prices and the elimination of heating subsidies to households would be implemented. Monetary policy had been tightened significantly before the currency board arrangement was introduced.

As the staff papers indicated, the value-added tax revenues would increase--although the rate would remain the same as the general excise tax--because the coverage would widen, the staff representative added. The effect of the direct impact of that tax would be about a 3 percent increase in the consumer price index, but the effect of the indirect impact had not been estimated. Over time, inflation was expected to fall from the past months' 2-3 percent.

On page 23 of the background paper, the staff had indicated the liberal rules concerning foreign direct investment, the staff representative remarked. The only remaining investment restrictions were in sensitive areas, such as defense and energy--for the moment. Although the staff had not recommended them, the authorities had provided tax advantages for foreign investors.

Unlike Estonia, which had a central privatization agency, Lithuania had merely a privatization board, the staff representative noted. The previous board had resigned at the beginning of the year as a result of the President's annual statement to Parliament, which had criticized that board for moving too slowly. In addition to resigning as head of the board, the Minister of Economy had resigned as minister as well, and a new board had been established. The background paper, in Appendix I, provided information on the plans for privatization and listed the number of enterprises and sectors that were scheduled for privatization in the initial proposal, the state enterprises, and those that would be privatized in another program.

With its new currency board, Lithuania would receive the same treatment as Estonia in the use of Fund resources, the staff representative added. It was assumed that purchases under the systemic transformation facility would be used for import financing--under the currency board arrangement, they would be held in blocked accounts with commercial banks, to be channeled through the banking system. However, other purchases under the 1992 and 1993 stand-by arrangements were held as reserves by the Bank of Lithuania.

In reply to Mr. Desruelle's question of whether a banking crisis was expected, the staff representative considered that it was difficult to foresee. If a run on banks occurred, $10 million, which had been set aside as a contingency mechanism, would not be enough. In any case, the Bank of Lithuania could access that $10 million as emergency liquidity support without consulting the Fund. The staff should expect, nevertheless, that it would be called in on extremely short notice to provide technical assistance. No resources in the budget had been set aside specifically for a banking crisis. At present, the World Bank was preparing a loan to restructure the financial sector. In the staff report, the staff had urged the authorities to cooperate with the Bank and quicken the pace of reform.

Ms. Laframboise made the following statement:

At the outset, we would like to commend the Lithuanian authorities on their perseverance with comprehensive stabilization measures and their commitment to macroeconomic discipline. We endorse the staff appraisal and thank the staff for their thorough analysis, particularly regarding the monetary and fiscal situation. We would like to make one comment on the new currency and exchange arrangements, then focus on structural issues, an area of the program which we find relatively weak.

On the new currency board arrangement, we have some reservations about the choice of the U.S. dollar as the anchor currency. Under a fixed exchange rate, we would have thought the litas should be linked to Lithuania's major commercial trading partners rather than the foreign currency most prevalent in the economy at the time of fixing--Germany, and the group of countries whose currencies are closely tied with Germany, come to mind. Furthermore, future shocks affecting the American and Lithuanian economies are very likely to be asymmetric, as exemplified by the divergent economic cycles currently existing between Germany and the United States. We would welcome any comments the staff may wish to make in defense of the U.S. dollar peg.

With respect to structural reforms, we would first like to recall the concerns raised by this chair, and at least one other, during the October Board discussion on Lithuania about the administrative allocation of foreign funds. As it turned out, the performance criteria on net lending by the Government was missed at the end of 1993, and the staff has since noted that this is the weakest aspect of the authorities' financial activities. In October, government intermediation of these funds was accepted as the best alternative in view of the limited progress in restructuring the banking system. We were very disappointed then to see that financial sector reform has not progressed materially since then, and that legislation governing commercial banks and the Bank of Lithuania Law has yet to be completed.

With three large state savings banks continuing to dominate the banking sector, an absence of competition has led to interest rate spreads that are higher than would prevail under a more competitive structure. More important, the loan portfolios of these banks are highly suspect, given their concentration on a sectoral basis in the past, and on many state enterprises that are likely to be insolvent. These problems perpetuate a poor allocation of resources and obstruct the need to enforce financial discipline on the state sector. Hence we would underscore the urgent need for comprehensive financial sector reforms designed to address the financial health of existing banks and increase the efficiency of financial intermediation. In general, noninflationary economic growth will depend on the ability of the economy to generate savings for private investment.

On state enterprises, we would just reinforce the need to accelerate measures on this front and fully endorse the following recommendations by the staff: to pass legislation on removing shareholder restrictions; to complete bankruptcy legislation; to accelerate the land restitution process; and to extend the range of enterprises eligible for privatization.

In view of the commitment demonstrated by the authorities and the considerable results obtained to date, we support the proposed decisions and would urge the authorities to focus on structural measures in the near term.

Mr. Isataev made the following statement:

The roaring success of the currency board arrangement in Estonia provides us all with a basis for forecasting a similar success in Lithuania, and the staff has confirmed that. I would like to ask the staff in this regard whether the currency board arrangement could be generally applicable to other countries of the former Soviet Union that have entered the second stage of the transition process, as is mentioned in the staff report, and particularly to those countries that are natural resource producers with good prospects for high foreign exchange reserves.

My second point is that Mr. Bergo's statement contains the encouraging information that valuable initiatives are under way to improve banking supervision in the functioning of the financial sector as a whole. Could the staff provide an update on the chances of early parliamentary approval of vital legislation on the central bank and commercial bank activities?

Mr. Havrylyshyn made the following statement:

I would like to add my voice to the previous speakers and praise the Lithuanian authorities for their remarkable achievements in the first two-and-a-half years after gaining independence. The structural transformation is well on track: the country has already successfully completed one stand-by arrangement and, currently, under the second, and the first purchase under the systemic transformation facility, the economy has recorded meaningful accomplishments with only one performance criterion--on lending by the Government--not met by end-December 1993. The inflation has declined tremendously--from a monthly rate of 20 percent at the second half of 1992 to

2-3 percent in the second half of 1993--and is expected to decline to a single digit annual rate at the end of 1994. GDP in 1994 is projected to grow--by 4-5 percent--after a sharp decline--over 50 percent--during the past three years. However, it has to be pointed out that in some areas, like restructuring of the financial sector, despite the efforts made, reform is falling behind, the banking system remains weak, and a thorough reform in legislation is badly required.

At this stage, while stabilization is still fragile, Lithuania is introducing major changes in the fiscal, monetary, and exchange areas whose successful implementation is crucial for its future. If the establishment of a currency board arrangement and the decision to peg the litas attracts more foreign investment and paves the way to full convertibility and if the value-added tax to be introduced in May 1994 will, as expected, strengthen the fiscal position, then there is no doubt that the country will step up to a higher level of sustained stability and a free market economy.

I will limit myself to two remarks, one related to wages and the other to private sector evolution. From Chart 1 of the staff report we see that, after a significant decrease in real wages up to May 1993, in the eight months to February 1994 real wages recovered sharply--by around 30-35 percent--while, according to page 5 of the staff report, only modest growth in output has been achieved in the second half of 1993. If this real wage increase continues to be so far out of line with output increases, it may result in demand pressures, raise inflation, and endanger the fiscal accomplishments.

My second remark relates to privatization and the role it plays in the broader phenomenon of private sector development. Unfortunately, the staff has been unable to provide much information on this except to show privatization is proceeding more slowly than desired. Other indicators suggest that in contrast new entries of private sector firms--especially, of course, small service-oriented ones--is burgeoning. I wonder if the staff could give at least a rough indication of the magnitude of this phenomenon, and more important, the extent to which competitive pressures from this sector are felt in hardening of budgets and efficiency improvements for state-sector enterprises. Related to this question is the shift of many state enterprises to joint-stock forms--the Basic Data Table in the background paper, as I understand it, shows more than 50 percent of employment to be in this category. My question is whether this shift, which clearly prepares the legal status for easier privatization, also have a benefit of imposing a harder budget on state enterprises? As a remark, I would suggest that future reports attempt as much as possible to provide more detail on the broader category of private sector evolution.

Finally, on the spontaneity of private initiatives where they are allowed to show themselves, I note the very illuminating lesson from Lithuania's bankruptcy experience. The staff report notes on page 8 that while the discipline of a clear and credible bankruptcy procedure is not yet in place, "some lawyers and judges have begun to specialize in bankruptcy, obviating the need to establish a special bankruptcy court." The lesson for transition here is that one need not wait for all market institutions to be in place before adjustment begins. Only the basics are needed to allow a spontaneous and mutually reinforcing evolution of these institutions.

I support the proposed decision.

Mr. Link made the following statement:

Like other Directors, I am pleased to note that despite the difficult circumstances Lithuania is making progress in the transformation of its economy, now under the second stand-by arrangement.

As all but one performance criteria for end-December 1993--on the net lending by the Government--have been observed by Lithuania and, in view of the steps being taken by the authorities to better control the net lending process and to channel an increased share of foreign assistance through the commercial banks, we support the proposed decision concerning the status of the stand-by arrangement and the use of fund resources under the systemic transformation facility for that country.

After the severe output declines in 1991 and 1992, it seems that industrial output in the state sector has stabilized in 1993. It is particularly encouraging to hear that the private sector is continuing to expand.

The surge in inflation toward the end of 1993, while perhaps partly owing to a number of special factors such as seasonal influences and the reduction of heating subsidies, was also due to the strong growth in reserve money and should be interpreted as a warning to the authorities to maintain a strong anti-inflationary policy. With the introduction of the currency board nominally anchoring the economy with a fixed exchange rate, external factors such as continuing surges of inflows of foreign currency and consequent rapid growth in reserve money could increasingly create inflationary pressures. If the exchange rate is undervalued, as it is apparently perceived to be, this adds yet another inflationary pressure. The staff states that "the authorities'" difficulties in responding to the surge in capital inflows that came with the initial success of the anti-inflation program contributed to a disappointing rise in inflation in the fourth quarter, but the implementation of the new monetary and exchange regime holds promise for an extended period of financial stability. We wonder why the staff is so optimistic in this respect, in view of Estonia's current battle with heavy capital inflows and inflationary pressures? The staff's comments would be appreciated.

Lithuania's budget is fairly well balanced. In light of the 1993 small budget surplus--1 percent of GDP--we have some difficulty in understanding why the staff feels that developing the social safety net would cause undue fiscal stress. We would like to express our support for the linkage of social benefits to the poverty line based on the cost of a subsistence basket. If necessary, additional measures should be taken on the revenue side to ensure that such benefits are adequate.

In the area of government sector wages, we are impressed by the fall in real wages of 50 percent with respect to 1991. According to the Lithuanian authorities, wage levels in budgetary organizations are very low even by local standards. However, decent wages in the government sector may be necessary in order to ensure that officers remain dedicated to public service and that incentives for corruption are removed. Fewer, more highly qualified and highly paid officials may serve the public interest better.

Enterprise reform has proved to be an extremely difficult task in all the reforming economies. It is encouraging to hear that a bankruptcy law has been adopted. A clear bankruptcy procedure should, however, be put in place as soon as possible so that all enterprises will be constrained to make their business decisions under hard budget constraints. Progress in privatization has been uneven. While quite a large number of small enterprises and housing have been privatized, the privatization of the large state enterprises is not proceeding as rapidly as planned. It is not quite clear to us what the role is today of the vouchers distributed to the population sometime ago. Could we have some more comments by the staff on it? It seems to me that the Government is now focusing more on finding strategic investors and has indeed succeeded to a certain extent in this respect. We agree that foreign direct investment should be encouraged, especially in the export-oriented areas in order to help diversify Lithuania's foreign trade structure.

The question of heating and energy subsidies in general is repeatedly mentioned in the staff report. In this context, we would like to take a closer look at the role played by Lithuania's energy bill in foreign trade. According to Table 7, imports from the Commonwealth of Independent States (CIS) countries accounted for 77 percent of all imports in 1993. Of this, 64 percent was energy imports--amounting to 50 percent of all imports--with much of this gas coming from the Russian Federation. On the export side, energy also played a crucial role as 26 percent of all exports were energy exports to CIS countries. Both on the export and import side, there have been some payment problems. Lithuania seems to be rather vulnerable in this respect. We would therefore recommend a continuation of price liberalization in the energy sector in order to enhance efficient use of energy resources both in households and enterprises.

Finally, the move to a fixed exchange rate regime under a currency board arrangement will support the Government's liberal trade policy. We would like to commend the Lithuanian authorities on simplifying the trade regime by eliminating quantitative restrictions and licensing and replacing them by tariffs. Furthermore, Lithuania has concluded a number of free trade agreements and is planning to pursue this policy with respect to the European Union and the Russian Federation. Let us mention in this context that a free trade agreement with Switzerland went into effect on April 1, 1993, as this was not mentioned in the list of such agreements given in the staff report.

According to the staff report, the Government made the decision to intermediate a large share of the first tranche of funds from the EU provided in the G-24 process itself, in part because of the banks' inexperience with credit analysis procedures. The Government therefore cleared investment projects through units in the ministries of economy and of finance. This action would imply that the government officials have more experience with credit analysis procedures than do the commercial banks, which we would find surprising, and it would seem to us that the commercial banks should be given the opportunity to handle these credits, learning credit analysis procedures in the process. In this way, balance of payments support can serve the double function of facilitating necessary imports and providing an important learning experience for commercial bankers. Financial sector reform--in particular the establishment of legislation governing commercial banks and the Bank of Lithuania--will be essential to create conditions necessary for optimal use of these funds.

Mr. Lvin made the following statement:

Lithuania has undergone a more complicated method of economic transformation relative to the other Baltic states. It could have demonstrated, perhaps, better performance than Latvia and Estonia because its economy has been less distorted: the share in output of military-oriented industries was definitely less significant; two major energy plants--Ignalina power station and Mazeikiai oil-processing plant--still are of great importance for the whole region; and, geographically, Lithuania has benefited because major North-South and East-West transit routes run through its territory.

However, in its pace of transition, Lithuania somewhat lagged behind the two other Baltic states. The most obvious proof is the data on the inflation rate and the exchange rate, as shown in the charts on pages 6c and 96b of the background paper. While 1993 was mostly a year of monetary stability in Latvia and Estonia, aggregates in Lithuania experienced a high degree of fluctuation. As a sign of uncertainty, the public heavily resorted to foreign exchange, and individual and private sector deposits of convertible currencies have risen more than twice over the last year. Another sign of instability may be seen in the rather erratic movements of interest rates and in the maintenance of very high interest rates in convertible currency transactions.

As the authorities were able to keep the national budget balanced or even in surplus, for which they deserve to be strongly commended, monetary management problems were identified as a main obstacle on the way to monetary stability.

The quality of the economic policy of any country should be assessed first of all with respect to its predictability. The means to provide for this predictability in the monetary area are generally dependent on the authorities' ability to resist sectoral pressures and on their forecasting and monetary management skills. Because the strength of the authorities' bargaining position is subject to changing political circumstances, and the necessary skills are likely to be--at least temporarily--out of place in the transitional economy, to waive the right of discretion in monetary creation at all should be regarded as the best solution. This is particularly true for a small economy whose impact on world trade and price setting is rather negligible. Therefore, the choice of the most rigid monetary arrangement in the form of a currency board seems fully justified. By taking this step the authorities effectively are tying domestic agents' monetary expectations to the much more predictable expectations of the anchor currency country.

It should be mentioned that a currency board arrangement would require that commercial banks and their customers follow, perhaps, a more prudent and cautious policy than their counterparts in the anchor country do, as they are not members of either the Federal Reserve System or the Federal Deposit Insurance Corporation. Such extra prudence may prove very useful at this early stage of economic transformation.

Following monetary independence, this step should become the next breakthrough in the process of Lithuania's reform, and it is understandable that the authorities have been completely pre-occupied with it in the past months. Nevertheless, some other outstanding issues, particularly of a structural nature, should be addressed promptly, as was stressed during the last discussion on Lithuania. I welcome the authorities' intention to clear these arrears, as underscored in Mr. Bergo's helpful statement.

Taking into account the rather weak administrative capacities, including those in the statistical area, which may preclude the authorities from making reliable forecasts as a necessary basis for discretional decisions, I urge them to capitalize fully on the opportunities provided by the currency board and to adopt a method of further liberalization in conducting economic activity. The staff notes an absence of restrictions on both the current and capital account operations, and I regard this as a welcome sign of such an approach. The immediate results of liberalization seem likely to be an increase in exports and foreign investment--which would reinforce the integrity of the currency board mechanism.

So far, the main concern is the authorities' fiscal position. Despite its extremely favorable performance, one may see it in jeopardy in the medium term. The ration of general government revenue to GDP has been steadily diminishing--from 43.9 percent in 1991 to 33.3 percent in 1992, and to just 25.1 percent in 1993. Therefore, pressure for reversing this trend may appear too strong in the near term. The well-prepared introduction of a value-added tax gains particular importance in this respect. Another means of alleviating such pressure may be found in substituting privatization of some state-funded activities for their compression. In particular, modalities of termination of extensive lending activities of the Government should be drawn down in order to avoid possible fiscal losses.

Finally, I would like to emphasize the importance of legal and institutional mechanisms of contract enforcement. Given hard budget constraints, guaranteed by the currency board arrangement, these mechanisms should become a major instrument in dealing with still state-owned enterprises.

With these remarks, I would like to express my full support of the proposed decisions.

Mr. Oya made the following statement:

I commend the authorities for their strenuous efforts at proceeding with economic reform and for having achieved an excellent track record. I also commend the staff for having provided useful and practical advice to the authorities in various areas, including the recent establishment of the currency board.

I was impressed at the Board meeting last October by the authorities' resolute commitment to economic reform for the transition to a market economy. The actions of the authorities described in the staff report renewed my pleasant surprise. I now fully recognize that the authorities are implementing each measure for economic reform according to their well-designed strategy during the transition to a market economy.

It goes without saying that the recent introduction of the currency board is one of the cornerstones of the strategy. I would like to start with comments on the currency board.

Generally speaking, in terms of the far-reaching impact of the adoption of a currency board arrangement on the economy, it is necessary to consider carefully the pros and cons. I agree with the staff that this change in monetary and exchange regime can be expected not only to contribute to reduced inflation and lower interest rates, but to provide a strong framework for the continued implementation of strict fiscal policies. However, the currency board could also hamper timely and flexible implementation of monetary policy and force the authorities to continue intervention in foreign exchange markets to maintain a fixed exchange rate.

In the case of Lithuania, however, I believe that the authorities laid a sufficient basis for the introduction of the currency board arrangement in advance, including tight financial policy for the containment of inflation and a continuous and significant effort in the foreign exchange market to stabilize the exchange rate.

Also, there is no denying that the authorities' commitment to stabilizing the economy is firm. In conclusion, I can support their bold decision to introduce the currency board arrangement.

With the introduction of the currency board arrangement, fiscal policy will become the main instrument for adjusting the economic situation. In this respect, enterprise reform, especially enterprise privatization, is a very important area in view of the possible bailouts for loss-making enterprises in the future. I join the staff in urging the authorities to take all necessary steps to minimize delays in the enterprise privatization process.

Finally, I would like to touch upon financial sector reform. It is regrettable that consideration on the draft Bank of Lithuania Law, which is urgently needed to provide a firmer foundation for bank regulation and supervision, has been delayed because the authorities have given immediate priority to the currency board proposal. At this juncture, delay in restructuring the weak banking system could have an adverse influence on lending activity and put additional pressure on a monetary policy that is already restrained by the introduction of the currency board. I hope that the authorities will complete all the procedures as soon as possible and show their resolute commitment to address this reform.

With these remarks, I support the proposed decisions.

Mr. Rouai made the following statement:

As we are in broad agreement with the staff's conclusion and support the authorities' policies, our comments will be made just for emphasis.

First of all, the authorities are to be commended for their bold economic reforms implemented so far with success. Nevertheless, much remains to be done in fiscal and monetary areas as well as on the structural front.

Fiscal policy is the cornerstone of Lithuania's economic program. In this regard, the authorities need to introduce more control on expenditures and monitor closely wages and social costs. Speeding up the pace of reforms in the tax area is necessary to modernize the system so as to generate more revenues. In this connection, we are pleased to note the introduction of the value-added tax, but we share the staff's concern about exemptions that should be narrowed to make this tax more efficient.

In the monetary sector, the adoption of the litas stability law is welcome. This will certainly strengthen the bank's supervisory function and give more independence to the central bank in designing and conducting monetary policy. With such an instrument, laxity in lending would be more difficult and resource allocation more efficient. Furthermore, the exchange rate of the national currency could be set at the right level and at the right time. Perhaps the staff could give us more information on this law as it relates to the above points.

On the structural front, reforms should be pursued with more determination, especially in the banking system and public enterprises. We share the staff's views that restriction concerning shareholding should be removed to encourage foreign direct investment in Lithuania. With regard to the social safety net, we believe that reform under way in collaboration with the World Bank could carefully define the optimum level of benefits that would be well targeted, and avoid cost overruns that could threaten the stability of the budget.

Concerning the balance of payments prospects, the large increase in the current account deficit programmed for 1994 seems a bit risky. Indeed, the deficit jumps to $330 million from $190 million. Could the staff comment regarding the downside risks of this development?

With these comments, we support the proposed decisions.

The staff representative from the European II Department considered that it was likely that the central banking and commercial banking laws would be passed quickly by Parliament. The central banking law was currently with Parliament, and the authorities had requested legal assistance from the Fund, which was expected to be granted quickly, for the commercial banking law.

In the past, real wages had fallen sharply and had overshot their target, the staff representative continued. Therefore, some increase in real wages was to be expected even before output recovered. Nevertheless, in the latter part of 1993, the speed at which real wages had grown had been cause for concern. In the first paragraph of the letter of intent that was signed March 22, 1994, the authorities had expressed their concern and their intention to monitor the situation closely. In February 1994, real wages had fallen slightly, so that it appeared that the pressure for the time being had not continued.

Unfortunately, there were no estimates on unrecorded private activity; however, throughout Lithuania, a substantial increase in private sector activity could be seen, particularly in the service sector, the staff representative remarked.

Mr. Bergo considered that the choice of an anchor currency had not been a controversial nor an obvious one, and that the reasons had been explained in the staff report. The relation of the dollar to the Lithuanian external sector was a significant one. Lithuania's trade with the countries of the former Soviet Union was denominated in dollars, as were foreign exchange transactions and current deposits. Furthermore, the rate of litas per dollar had been monitored over a considerable period of time; thus, the exchange rate had a history. In considering, choosing the deutsche mark would not have been controversial, either.

The authorities recognized that the currency board arrangement was not a panacea to cure all ills in the Lithuanian economy, Mr. Bergo continued; nevertheless, it was a bold move forward that would protect and enlarge upon the macroeconomic gains that had been made. His authorities were determined to make full use of the institutional framework of that arrangement to make important advances in securing noninflationary growth and continued structural reform.

During the discussion on Lithuania in October 1993, Mr. Bergo recalled, Mr. Posthumus had said that he hoped that the transformation process was safely on course, and Mr. Solheim had replied that he was certain that it was. The intervening period had shown that that course had been a correct one, and that an increase in the pace of reform was both safe and advisable.

The staff representative from the Policy Development and Review Department said that there were several points to consider in judging the applicability of Lithuania's currency board arrangement to other economies in transition. First, an important benefit with a currency board arrangement was that a country effectively insulated its financial and monetary policy from political intervention. However, the state of the economy, the macroeconomic situation including especially the access to foreign reserves, and the stage of transition had to be considered. The state of the banking system and the adequacy of banking supervision were also relevant. Second, care had to be taken in setting the exchange rate--as Mr. Dorrington had said, the country had to live with that decision for a long time--because the currency board was the purest form of nominal anchor. Subsequently, if a change in the real exchange rate was needed as a result of developments in productivity or structural policies, the authorities would not have the flexibility of achieving it by changing the nominal rate. Therefore, one could not generalize that transition economies, or any group of economies, would always benefit from a currency board--that would depend greatly on the state of transition, the opportunity cost of foreign reserves, and the weight one places on the different factors.

Third, where a currency board arrangement did not exist, the staff usually examined closely whether the country's economic program had a credible nominal anchor, the staff representative from the Policy Development and Review Department remarked.

The Acting Chairman made the following summing up:

> Directors welcomed the progress that has been made by Lithuania in effecting economic stabilization and structural reform under difficult circumstances. They expressed the hope that the progress made to date will further catalyze the economic recovery that is beginning to take hold, but cautioned that the still-fragile recovery remained dependent on continued progress in stabilization and reform.
>
> Directors were in broad agreement with the staff appraisal. They particularly welcomed the recent declines in inflation and the restoration of tight monetary policy in early 1994, and congratulated the authorities on the successful introduction of a currency board arrangement on April 1. They noted that the adoption of a currency board arrangement was an important step toward achieving lasting financial stability and lower interest rates, but noted that this was a demanding arrangement and would

require, at a minimum, strong support with fiscal restraint and continued structural reforms.

Directors praised the authorities' track record on financial discipline, noting especially the achievement of a surplus in the general government financial balance in 1993. They welcomed the upcoming implementation of the value-added tax as an important tax reform measure. They pointed out, however, that further action to strengthen tax compliance and to reform the tax system was needed, and welcomed the authorities' determination to make this a priority issue.

While commending the authorities on recent financial system reform measures, Directors noted that the banking system remains weak. They encouraged the authorities to move rapidly to pass new central and commercial banking legislation. Directors also regretted the delays in enterprise reform, as well as delays in the elaboration of a privatization program. Noting that a number of legislative measures are before Parliament, they recommended rapid action to accelerate reforms in this area.

Directors also expressed concern about the lack of progress in reform of the social safety net. While welcoming the planning under way in this area, they cautioned that more attention needs to be paid to potential costs and necessary improvements in administration in designing the reforms. Directors also drew attention to the lack of progress in reforming unemployment benefits.

Directors noted the significant progress that has been made in the area of trade reform. While recognizing that remaining export tariffs still need to be lifted as planned later this year, and a few high import tariffs still need to be reduced, Directors praised the authorities for their progress in this area, and noted that an open trading system was in the long-term interest of a small open economy such as Lithuania.

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

The Executive Board took the following decisions:

<u>Review Under Stand-by Arrangement</u>

1. The Republic of Lithuania has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for the Republic of Lithuania (EBS/93/164, Sup. 3, 10/25/93) and the last paragraph of the letter of the Prime Minister and the Acting Governor of the Bank of Lithuania dated September 30, 1993.

2. The letters of the Prime Minister and the Governor of the Bank of Lithuania, dated March 22, 1994 and April 5, 1994 respectively, shall be attached to the stand-by arrangement, and the letter dated September 30, 1993, with annexed memorandum, shall be read as supplemented and modified by the letters dated March 22, 1994 and April 5, 1994.

3. Accordingly,

(a) The performance criterion set out in paragraph 3(a)(iii) of the stand-by arrangement for March 31, 1994 shall be as specified in Annex I of the letter dated March 22, 1994.

(b) The performance criteria set out in paragraphs 3(a)(i), 3(a)(ii), 3(a)(v), and 3(a)(vi) of the stand-by arrangement for June 30, 1994 and September 30, 1994 shall be as specified in Annexes IV and V of the letter dated March 22, 1994.

(c) Effective July 1, 1994, and for test dates beginning June 30, 1993, the following modifications shall be made to the stand-by arrangement,

(i) Paragraph 3(a)(iii) shall be deleted and replaced with "the floor on reserves of the banking system described in paragraph 6 and in Annex II of the letter dated March 22, 1994, or".

(ii) Paragraph 3(a)(iv) shall be deleted and replaced with "the floor on the net international reserves of the Bank of Lithuania described in Annex III of the letter dated March 22, 1994 and in the letter dated April 5, 1994, or".

(iii) At the end of paragraph 3(b) after "or", there shall be added, as paragraph 3(b)(iii), "the maintenance of full foreign currency backing for the currency board's liabilities at the end of each monthly reporting period as described in paragraph 6 and in Annex II of the letter dated March 22, 1994; or".

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

Decision No. 10644-(94/32), adopted
April 8, 1994

Purchase Transaction - Systemic Transformation Facility

1. The Fund has received a request by the Government of Lithuania for a purchase equivalent to SDR 25.875 million under

the Decision on the Systemic Transformation Facility, (Decision No. 10348-(93/61) STF, adopted April 23, 1993).

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 10645-(94/32), adopted
April 8, 1994

5. TURKEY - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered a staff report for the 1993 Article IV consultation with Turkey (SM/94/54, 2/28/94; and Sup. 1, 4/7/94). They also had before them a background paper on selected background issues and statistical appendix (SM/94/58, 3/7/94).

Mr. Kiekens made the following statement:

During the past year the Turkish economy has continued its familiar pattern of robust output growth combined with high inflation. Real GNP growth, at some 7 percent, was considerably higher than expected earlier and gave Turkey the highest growth rate in the Middle East and Europe area, barring the special case of Kuwait. As Turkey's main export markets in Europe were mired deep in recession, it is hardly surprising that booming domestic demand conditions fed domestic inflation and exerted pressure on the external current account. At the time of the recent consultation mission to Ankara, my authorities agreed with the staff's analysis that expansionary fiscal policies had helped increase domestic and external pressures, and recognized that quick corrective action would be needed if the economy should encounter external financial constraints. But because they did not expect such constraints to surface in the very short run, they opted to continue their strategy of gradual fiscal consolidation.

As it turns out, however, Turkey became one of the countries where events related to the political calendar have triggered a financial crisis: the first quarter of 1994 has been marked by turmoil in the stock and foreign exchange markets notwithstanding the vigorous efforts of the monetary authorities to stabilize the situation. Here let me stress that my authorities never once considered imposing regulatory measures that would even temporarily have suspended the financial market liberalization achieved in past years. Instead, they accepted the behavior of the financial markets as a signal of lost confidence in the validity of their policy stance and a call for additional fiscal adjustment to create better macroeconomic conditions for sustained and non-inflationary output growth.

In response, my authorities announced on April 5, immediately following the nationwide local elections, a comprehensive set of adjustment measures which should go a long way toward meeting the concerns expressed by the staff in their consultation report. These measures fall into two main groups. The first group consists of demand-restraining measures aimed at achieving a sizable reduction of the budget deficit which, by reducing the inflation rate and the external current account deficit, will reassure the markets and stabilize expectations. The second group consists of supply-side measures aimed at softening the deflationary impact of the demand-restraining measures by improving the outlook for export-oriented growth.

The first group of measures amounts to a short-term stabilization program, which is added to the previously adopted fiscal adjustment package aimed mainly at increasing tax revenues. The new measures have three objectives: sizably reducing the budget deficit, primarily by cutting expenditures; enhancing the credibility of fiscal policy; and, eliciting broad support for the fiscal adjustment effort. A whole series of measures is aimed at the deficit-reduction goal: strict adherence to the budget allocation for personnel expenditures will virtually freeze the nominal wages of government employees during the second half of the year and, together with a freeze on new hiring, will lower the GDP share of budgetary personnel expenditures; investment spending for the current fiscal year will be cut by an additional 10 percent, and other current expenditures will be cut by 30 percent; in addition, substantial one-time price increases for the products of the state economic enterprises (SEEs) will reduce their financial burden on the consolidated deficit. The second goal, of enhancing credibility, will be pursued by announcing a nominal budgetary deficit target every quarter, starting with the second quarter of this year, and then strictly observing it. The third goal, of eliciting broad public support, will be pursued by spreading the burden of adjustment over all segments of society while building a social consensus on the need for further fiscal restraint. Here it is worth mentioning the one-off taxes being imposed on the corporate sector, on real estate, and on luxury vehicles. The increased progressivity of the personal income tax, included in the recently enacted tax reform package, will also help by distributing the fiscal burden more equitably. And the introduction of an effective and financially balanced unemployment compensation scheme should further strengthen the social consensus in favor of adjustment.

An additional payoff of this extensive package of fiscal measures is that they will also help reduce inflation. Besides directly acting to reduce demand, observance of the quarterly nominal budget deficit targets will dampen inflationary expectations and help reverse the inflationary momentum that has been insidiously invading the Turkish economy. Moreover, my authorities hope that the reduction of real wages in the public sector, followed by declining inflation rates, will finally put an end to Turkey's traditional backward-looking wage indexation practices. In that case they expect that the private sector, with its tradition of real wage flexibility, will follow suit and adopt forward-looking practices to compensate inflation.

The reduction of the budget deficit will increase the effectiveness of monetary policy as an instrument for containing inflation. The Central Bank will establish a new set of quarterly credit targets based on the new budgetary targets, which will put inflation on a declining path once the initial impact of the currency depreciation and the price adjustments have been absorbed. The Central Bank's control over monetary aggregates will be strengthened by modifying the reserve requirement practices and liquidity ratios to be observed by banks. The statutory limit on central bank advances to the Treasury will be lowered from the present 15 percent to 3 percent of the budget over a four-year period. And the Central Bank will be given more independence in the period ahead.

Let me turn now to the second, supply-side part of the new adjustment package. My authorities have decided to reinforce their original set of structural measures to make the economy more quickly responsive to any pickup in foreign demand that might partly offset the compression of domestic demand. In the medium term, these same measures will increase the general efficiency of the economy and thus help boost output growth. Perhaps the most important change is a much stronger emphasis on privatization: it has been decided to accelerate the privatization of public enterprises, including those in the financial sector, and Parliament will very soon consider a law to eliminate the legal and institutional hurdles that have frustrated privatization in the past. Scarcely less important, the SEEs will now become subject to commercial law, which will force them to behave like private corporations. In addition, my authorities have committed themselves to downsizing or even closing state enterprises that cannot be privatized or otherwise rehabilitated owing to high production costs, backward technologies, or the disappearance of markets for their output. Of course, all measures applicable to the SEEs will have the added advantage of reducing the budget deficit in the short run.

There are other structural reform measures, already decided earlier and highlighted in the staff report, which serve to underline my authorities' steadfast commitment to the implementation of efficiency-enhancing measures. These include measures in three areas where many other countries are proceeding with caution. The first is liberalization of the trading system: Turkey firmly intends to complete the customs union with the EU, despite the fragility of its external current account. Second, in the area of agricultural support, my authorities are engaged in cutting back subsidies and replacing indirect with direct and more transparent subsidies. And third, in the financial sector, deregulation and innovation are spurring changes that will improve the process of financial intermediation in Turkey.

My Turkish authorities firmly believe that this newly announced set of comprehensive adjustment measures will rebuild confidence, halt the decline in the exchange rate of the Turkish lira, and bring a renewal of capital inflows. The current exchange rate level of the Turkish lira has improved external competitiveness, and tight demand management policies should prevent this improvement from eroding. A return to more settled conditions in the foreign exchange market will signal the restoration of confidence in Turkey's economic policies, both at home and abroad. This will pave the way for a reversal of the currency substitution process in Turkey and a decline in the risk premium on foreign loans to Turkey, and considerably improve the country's ability to finance its balance of payments.

Mr. Havrylyshyn made the following statement:

During the last decade Turkey's economic performance has been excellent. One sees relatively high rates of growth, averaging 5-7 percent on an annual basis; continuous strong export growth; a reasonable, though not outstanding, level of gross fixed investment and a remarkable increase of foreign direct investment. All this justifies thinking of Turkey as a leading country in the region and one of the fastest growing "emerging markets" in the world. Perhaps the most important achievement of the central authorities underlying this success was the significant liberalization and modernization of the trade and exchange system. This also led to the integration of the Turkish economy in the global family of the open economies. It is to me a source of amazement and deep concern that such achievements have been made despite a high and continuously deteriorating fiscal imbalance. Resolving the paradox of a great success in outward-oriented growth, in parallel with a great failure in achieving fiscal prudence, lies at the heart of Turkey's future economic policy orientation. The paradox can be explained by two observations. First, the rapid economic expansion has both provided the savings--domestic and foreign--to finance fiscal imbalances, and permitted a complacency about the need to deal with those imbalances. But, second, the willingness of domestic and foreign economic agents to provide such financing is not everlasting and, with the volatility that is so common to private investors, may come to a sudden reversal. When it does, the shocks will be far greater than any austere program of fiscal consolidation. The continuous deterioration of the country's external account position and the recent news about 28 percent devaluation of the Turkish lira against the U.S. dollar are just initial warning signs of this danger.

Given all this, I fully endorse the staff's insistence on determined economic measures and sizable and durable macroeconomic adjustment. This will be the only way in which the Turkish authorities will succeed in arresting further deterioration of the public finances, bringing down the inflation rate, restoring current account equilibrium in a medium-term perspective, and ensuring the confidence in Turkey's economic potential which has so far sustained its remarkable growth achievements. I would like to elaborate on some specific issues.

I certainly agree with staff's view that the primary cause of the deep fiscal imbalances and the persistent high inflation is rooted in the growing fiscal deficit. Despite the positive achievements in reducing the public sector borrowing requirement/GDP and central government debt/GDP ratios in the late 1980s both indicators began to rise dramatically from the early 1990s, reaching 17.0 and 26.8 percent in 1993, respectively. Adding to these results an expected fiscal deficit/GDP ratio of 12.3 percent, I would definitely encourage Turkish authorities to make a bold--and sustained--fiscal adjustment. Therefore, I would, with the staff, urge the authorities to an early move toward a primary surplus, having in mind that the primary surplus is a main prerequisite for stabilization of the ratio of debt to GDP.

An important adjunct to improvement of the budget performance is curtailment of personnel expenditure. In the case of Turkey these expenditures were one of the important contributors to the aggregate demand and inflation growth. In this context I would suggest decisive steps for moving away from the present backward-looking wage indexation toward setting nominal wage indexation consistent with forward-looking inflation.

Another important issue is the monetization of the central government debt, a concrete example of the paradox mentioned earlier. While financial markets have developed tremendously, making Turkey one of the leading emerging capital markets, the mechanisms still used for financing government debt have lagged behind the sophisticated instruments available in these financial markets. The staff has provided in the supplement to the staff report a thorough analysis of consolidated budget interest payments and the interest rate structure. As the analysis indicates, a significant part of the fiscal deficit--about 30 percent--is financed through central bank advances, which carry a 4 percent annual interest rate. The striking difference between this rate and the rate prevailing on the interbank market--about 70 percent on annual basis--urge me to warn that such a difference plays and will play an important distortive role all over the financial markets and contributes to the complacency about the need for fiscal adjustment. The staff's comments on this subject and on the steps taken for improving this situation would be very welcome.

Equally important is the matter of Turkey's exchange rate policy. This issue increases in importance especially after the freshly announced austerity plan and a 28 percent devaluation of the Turkish lira. In that connection I would like information from the staff on the options for future exchange rate policy in Turkey. Some comments concerning the impact of the new devaluation on the freshly established plan and Turkey's economic performance would be also very helpful.

Finally, I would like the staff to comment on the newly announced austerity plan. Is it too little too late? Or perhaps too much too late? Or is it just the right first bold step to resolve the paradox of high growth and high deficits and avoid the even more austere shock that private economic agents would eventually force upon Turkey?

Mr. Mirakhor made the following statement:

On the occasion of the last Article IV consultation with Turkey, this chair argued that the Turkish economy presented a picture of striking contrasts. On the one hand, it was an economy in which extensive structural reforms and external liberalization had produced one of the most impressive examples of successful export-led growth. On the other hand, overexpansionary macroeconomic policies had led to high, though stable, inflation. We had urged the authorities to bring about a decisive reorientation of economic policy so as "to reduce the very real risks of an erosion of the gains [Turkey] had made over the last decade and a half."

These contrasts deepened in 1993. The year saw another period of robust growth and buoyant economic activity: real GNP increased by an estimated 7 percent while private investment continued to surge in anticipation of Turkey's entry in 1995 into a customs union with the EU. Turkey's stock market in 1993 was among the fastest growing of the world's emerging markets and continued to attract substantial inflows of direct and portfolio investment.

But 1993 was also marked by mounting evidence that the strain created by the persistent weakness of macroeconomic management was beginning to take its toll. This was most vividly illustrated by the sudden and sharp deterioration in the external position that, in the past, had demonstrated a remarkable degree of resilience in the face of large fiscal imbalances and exogenous shocks and had served to offset the nominal instability of the economy. To be sure, the current account found ready financing and should not therefore have been a cause for undue alarm; however, the shift in the composition of financing toward short-term capital was ominous. On the domestic side, Mr. Havrylyshyn has already commented on the distortive methods of deficit financing and the worsening picture of domestic debt amortization. The resulting unsettled conditions manifested themselves in the exchange market and led to growing concerns that the cushion hitherto provided by the external sector was being rapidly eroded and inflation was set to accelerate to new heights with all its attendant consequences.

In his statement, Mr. Kiekens suggests that the flash point of Turkey's financial crisis stemmed from the uncertainties arising from the run-up to the provincial elections and its aftermath. This statement is no doubt true. However, Turkey's present difficulties mostly stem from more deep-seated causes, namely, the inability to come to grips with growing and unsustainable macroeconomic imbalances. Although a start had been made in reducing the primary deficit in 1993, this effort proved insufficient to generate the kind of positive expectations needed to set the stage for a successful disinflation effort. On the contrary, inflationary pressures remained high, wage settlements continued to be generous, and an unsustainable consumer-led boom added to domestic demand pressures at a time when the pace of export growth slowed. The confluence of these developments led to the heightened vulnerability of the external position and pushed the economy to the brink of financial disorder and hyperinflation. Let me hasten to add that it is highly commendable that, as Mr. Kiekens points out, the authorities did not resort to regulation and restrictions to stabilize the situation.

It is against this background that we welcome the authorities' recently announced plans to address the root causes of the economy's difficulties. In this context, it is unfortunate that the Board has not had the benefit of a staff evaluation of the stabilization package announced by the Prime Minister on April 5. I know the staff had to work hard to put together the factual supplement in time for the Board discussion. But in the absence of a full staff appraisal, and considering the late availability of the supplement, what follows reflects my best judgment of the strength of the measures announced on April 5.

These measures appear to constitute a significant and comprehensive agenda of actions. They need to be implemented with the determination and firmness that is appropriate to the situation. It is also imperative that these important initiatives be followed up by further resolute actions over the medium term so that the Turkish economy can be returned to a path of rapid growth in the context of a sustainable macroeconomic situation and low inflation.

The stabilization component of the authorities' adjustment package appears strong and well balanced. We welcome in particular the emphasis on the planned reduction in the fiscal deficit and the reassertion of central bank control over monetary aggregates. These are essential first steps to regaining control over macroeconomic policy. The strict observance of ceilings on the quarterly nominal budget deficit and, correspondingly, of quarterly credit targets, will be crucial to establishing the credibility of the authorities' efforts at lowering inflation and rebuilding confidence.

The economic and social costs of the front-loaded adjustment package are difficult to assess but could be substantial. They could imply a more drastic adjustment than suggested by the staff's "sharp fiscal adjustment" scenario. The authorities hope that a slowdown in the momentum of domestic demand will make way for a higher level of exports and thereby cushion the impact of falling domestic demand on output. With competitiveness restored along with recovery in Turkey's key export markets, this could well happen. However, preserving the gains in external competitiveness will require ensuring that the price shock emanating from the revenue-raising measures in the budget is limited to a one-time effect and is not fed into core inflation. This can only be achieved by tight macroeconomic policies and firm wage restraint. In regard to the latter, we wonder whether, as we argued during last year's consultation, the time is not ripe for forging a formal consensus among the social partners on the desirability of wage objectives that are in line with a target path of decelerating inflation.

Turning to exchange rate policy, the authorities appear to have decided that the exchange rate should be allowed to float and find its own level in line with market forces. However, the question again arises whether, once the process of disinflation gathers momentum, Turkey might not benefit from a more stable exchange rate regime with the exchange rate providing a full or a "dragging" anchor, as suggested by Mr. Schoenberg last year, for the domestic price level. Such a move could bring a powerful reinforcement to the task of subduing inflationary pressures.

The authorities' supply-side measures are bold and far-reaching. However, realizing the target for revenues from privatization will still depend on the difficult and uncertain prospect of securing parliamentary approval. The fact that this has frustrated previous attempts at privatization should not deter the authorities from garnering the necessary political support to ensure that the legislation is passed. I am more concerned about the authorities' decision to close certain state enterprises in the absence of an adequate and well-funded social safety net. I am aware that there is a proposed unemployment insurance law and a loan from the World Bank for retraining and relocating the workers, but perhaps Mr. Kiekens or the staff can give us more information on the timing of these measures and whether they will be of help to the present plans for labor retrenchment.

In general, the measures announced may well be sufficient to restore stability and confidence in the Turkish economy. Its full implementation in the short term, and perseverance with efforts to restore confidence through continued fiscal consolidation over the medium term, will be crucial. No doubt pressures will arise to relax policies as the full impact of the painful but necessary measures takes hold. The authorities must resist these pressures and stand firm in the task that they have set for themselves. In the context of the authorities' medium-term stabilization and growth strategy, continuous and close dialogue with the Fund will certainly be helpful to the authorities and I am certain that they will avail themselves of this opportunity.

Let me conclude by saying that this Board meeting is important for Turkey. In view of the rating agencies' recent actions and the degree of nervousness in the international markets, positive words from the Fund at this stage could go a long way to calm the crisis mentality that exists both in Turkey and outside. It is important to note that the Board's assessment of economic conditions in Turkey has a vital and sensitive role to play at this juncture in the evolution of the Turkish political economy. It is imperative, therefore, that the current crisis be placed in its proper context vis-à-vis the longer-term prospects of the health of Turkish economy. There can be no doubt that that prospect remains bright.

Mr. Havrylyshyn noted that he would like to revise the question he had asked earlier in his statement; he wondered whether the staff could indicate what the possibilities were of achieving the harsh and quick adjustment proposed in the austerity program.

Mr. Al-Jasser made the following statement:

Turkey's economic performance since the 1980s has been impressive. The important structural, foreign trade, and financial liberalization measures implemented have propelled Turkey into the position of the fastest-growing member of the OECD. The performance of the export sector has been particularly impressive, with the average export growth rate being one of the highest in the world.

This success notwithstanding, recent economic developments are a source of concern. At the center of Turkey's current economic difficulties is the large and growing public sector borrowing requirement owing, for the most part, to insufficient policy action. While the Government was able to reduce the primary deficit in 1993, the public sector borrowing requirement continued to be large and increasing as a result of an increase in personnel expenditures, interest payments, and the deficit of the extrabudgetary, revolving, and social security funds. Data deficiencies are complicating the fiscal consolidation process further, because they hamper the oversight of the state enterprises. Clearly, addressing these problems requires reforms of the structure of the budgetary process, a critical examination of public sector activities, and measures to raise revenues and reduce expenditures.

Against this background, I welcome the frank and courageous conclusion of the authorities, as they grappled with the serious turmoil in the financial markets. As Mr. Kiekens put it, "...my authorities never once considered imposing regulatory measures that would even temporarily have suspended the financial market liberalization achieved in the past years. Instead, they accepted the behavior of the financial markets as a signal of lost confidence in the validity of their policies and a call for additional fiscal adjustment to create better macroeconomic conditions for sustained and non-inflationary output growth." The "extensive package" of measures announced by the Turkish Government amounts, in my view, to a "fiscal shock therapy." Obviously, the authorities wanted to put in place a very credible response to a very difficult situation. Mr. Kiekens's statement and the supplement to the staff report are very reassuring in this regard, especially the staff statement that "the basic design of the program seems to be in accord with principles applied successfully elsewhere."

The elements of the economic package appear to strike an appropriate balance between policy instruments and structural reforms while providing realistically ambitious targets. Accelerating the privatization process and the closure of loss-making state enterprises is, of course, essential to the adjustment's success. The authorities' success in raising Turkey's status as an emerging financial market will no doubt facilitate the acceleration of the privatization process. Attention should now be focused on the legislative process needed to implement these measures. Further reforms to the structure of the budgetary process also seem to be warranted.

The credibility of the measures to be implemented is as critical as their actual magnitude. Here, I welcome the intention of the authorities to announce, and to ensure strict adherence to, a budgetary deficit target every quarter. Certainly, given the expected increase in unemployment, broad public support is crucial to reduce pressures on government expenditures. Like Mr. Mirakhor, I would be interested in comments from the staff or Mr. Kiekens on the possible contribution of the World Bank in the design and implementation of an appropriate unemployment compensation scheme.

The very multiplicity of reforms and measures needed, the time required to implement them, and the growing sensitivity of Turkey's economy to the reactions of the financial markets underscore the difficulty of the task ahead. It will be therefore crucial that the authorities pay due regard to the sequencing as well as the pace of the reforms. In sum, at this critical juncture of the stabilization and reform process, the onus is on the implementation of the package.

Successful implementation of the envisaged reform measures will undoubtedly reduce the burden on monetary policy during this delicate phase of adjustment. I particularly welcome the authorities' intention to free the Central Bank from the burden of financing the budget deficit. Mr. Havrylyshyn's points on this matter are well taken. It seems from the papers before us that moves in this area have to be gradual, despite the obvious shortcoming of such an approach, as there remains a risk that bond financing may place public debt on an explosive path. Clear moves in this direction will, nevertheless, be needed soon in order to ensure the success of the monetary program. I therefore welcome the timetable to reduce substantially the legal limit on short-term central bank advances to the Treasury.

Strict adherence to the fiscal targets will most likely prove to be the only guarantee for the stability of the exchange rate. The devaluation of the lira, and the subsequent floating of the exchange rate, should allay the staff's concerns regarding the competitiveness of the real exchange rate.

While export performance stagnated during the past year, it is noteworthy that Turkey's export sector has generally performed extraordinarily under difficult external and internal circumstances. This attests to the success of the liberalization measures of the past. It is my hope that Turkish exports will enjoy greater access to the world market, especially following the implementation of the customs union with the European Union.

With these comments, I wish the authorities every success in stabilizing their financial market and, subsequently, realizing the bright potential of the Turkish economy.

Ms. Lissakers made the following statement:

This Article IV review comes at a very critical time for Turkey. Data based on the year-end review paint a picture of an economy running badly out of balance. Since then, the economic situation has run further out of control.

A drastic deterioration of the account deficit, reaching just over 5 percent of GNP, complicates matters very seriously. The authorities' inability to regain control over public finances led to the emergence of a public sector borrowing requirement of over 17 percent of GDP, almost twice the original target level. Heavy financing of the deficit through the Central Bank has exacerbated what was already a chronic inflation problem, leading to an inflation rate of 74 percent at the end of March. Additional recourse to external borrowing raised the external debt to $66 billion and led to a debt/GNP ratio of 60 percent. As Mr. Havrylyshyn quite rightly points out, financial markets are fickle; this week's favored borrower may become next week's pariah. International markets have taken note of the drastic deterioration in Turkey's economic situation, twice downgrading Turkey's debt rating this year. The resulting exchange market volatility detailed in the staff's statement translated into a rapid depreciation of the lira and skyrocketing interest rates. The combination of high inflation and soaring interest rates creates the conditions for continued dynamic instability that runs the risk for the Government that its ability to retrieve the situation will be crippled.

The staff's statements in the report at this point come as something of an understatement: the need for a medium-term strategy that would give the public a clear sense of direction of fiscal policy and the authorities' commitment to macroeconomic discipline; and that the present situation "does not allow much scope for gradualism." The new economic adjustment program announced by Prime Minister Çiller this week can hardly be called gradual, and it comes, as I said, at a very critical time.

Although details of the program are still unclear, the broad outlines appear to have the appropriate focus on reducing substantially the fiscal deficit, bringing monetary aggregates under control, and intensifying structural reform efforts to facilitate the adjustment process. The dire state of Turkey's economy requires the strongest medicine at this point. The ambitious targets laid out in the plan move in that direction.

The credibility of the plan, of course, rests on how it is implemented, as Mr. Al-Jasser has already noted.

The new program's inclusion of quarterly budget targets should impose discipline on the authorities and increase investor confidence. The few numbers we have seen associated with the new program indicate that the targeted second quarter consolidated budget amounts to a downward revision of 80 percent from the original target--a very ambitious goal, to say the least. Price increases of state enterprises' products, wage freezes, sharp reductions in investments, and tax reforms are listed as the primary tools. Having noted the staff's skepticism in the report regarding the feasibility of meeting the original 1994 fiscal targets, any views on whether the intended measures in the new package will be sufficient to meet the quarterly target would be appreciated. We would pose the same question with respect to projected revenues from privatization and state-owned enterprise reform in the new program, amounting to $3.5 billion in 1994. Given Turkey's weak track record on the privatization front, clear progress in the near term will be essential to convince market participants of the program's credibility. Finally, the staff paper notes that reducing inflation expectations will require the realization of a primary surplus of at least 3 percent of GNP. Can the staff or Mr. Kiekens comment on whether the new program will meet this target, and, more generally, whether the authorities are prepared to take additional measures if results fall short of those fiscal targets?

Turning to the monetary sphere, we welcome the authorities' return to announcing quarterly monetary targets under the new program. Most important will be restricting the public sector's access to central bank financing. The staff report and background paper on recent economic developments note that the overall average interest rate on the central government's public debt is negative in real terms, with the Central Bank providing most of the below-market financing. As the staff point out, this amounts to the virtual monetization of the deficit. The new program's commitment to lower the limit on short-term central bank advances from 15 percent to 3 percent of budgetary outlays by 1998 is therefore an important first step. We would encourage the authorities to outline in advance the pace and scale of reductions, accelerating the schedule where possible. Of course, the ultimate goal should be the elimination of public sector access to central bank financing. We welcomed the indication in the staff's supplement that monetary policy would be "geared to a sharply curtailed growth in base money." Could the staff or Mr. Kiekens provide further clarification of the authorities' monetary targets under the new program?

The authorities' recent decision to float the exchange rate was prompted by the enormous pressure on the currency stemming from spiraling inflation. While there is some virtue in increasing the role of market forces in exchange rate determination, we are concerned that the underlying inflation dynamics create the potential for an uncontrolled explosion of the rate. In our view, a clearer strategy is needed for integrating exchange rate policy into overall inflation management, and we would welcome the staff's views. Furthermore, we noted in the recent economic developments report that foreign currency deposits in Turkey constituted close to 85 percent of M2 at end-1993. The high degree of foreign currency substitution in the financial system intensifies the impact of the rapid depreciation. The risks of dynamic instability are serious. The depreciation directly increases the budget deficit by increasing the local currency cost of servicing foreign debt. At the same time, the shrinking lira base reduces the opportunity to close the deficit through an inflation tax.

We commend the Turkish authorities for announcing a program that, if implemented fully, should go a long way toward getting the Turkish adjustment program and its economy back on track. Drastic reduction of the fiscal deficit, tighter monetary policy, accelerated privatization, and closure of inefficient state-owned enterprises will cut to the core of the inefficiencies in Turkey's economy. Investors, of course, will base their assessment on the authorities' commitment to reform, the timing and scope of implementation, and the authorities' willingness to take additional steps if needed. International markets might also place value on an enhanced monitoring role by the Fund. If Mr. Kiekens or the staff has any insight on the potential for closer cooperation with the Fund, we would welcome their comments.

Just to close, I would like to underscore that one must not lose sight of the tremendous success Turkey has achieved over the past decade in maintaining dynamic economic growth, diversifying the composition of its exports, and improving the well-being of the Turkish people. We think that the Turkish economy and its political structure certainly have the vitality and the strength to work through this very difficult situation, and with the other members of the Fund we expect to be as supportive as we possibly can of this very strong and ambitious adjustment program.

Mr. Dorrington made the following statement:

The Turkish economy is in the middle of a critical period. The alarming size of the public sector borrowing requirement in 1993 has fueled the inflationary spiral and helped generate unsustainable growth in demand. In turn, imports have been sucked in, and the resulting balance of payments deficit is now very wide and opens up the issue of whether--or at what cost--it can be financed. The staff appraisal is strongly worded but does not, I feel, overestimate the dangers of the present position. I can agree broadly with its conclusions.

Since the staff papers were issued, economic events have moved rapidly in Turkey. The new economic austerity package seems to touch all the right areas. If it is implemented in full, it will go a significant way toward doing what the staff has rightly identified as being needed. I agree with Mr. Al-Jasser that the credibility of the measures is as important as their magnitude. I welcome it as a first step, but I stress that the problems facing Turkey will take much longer than three months to put right.

In the area of fiscal policy, it is clear that urgent action is required. The deficit appears to have arisen mainly through unchecked expenditure and subsidies. And the recent devaluations will have served to increase external debt-servicing costs because Turkey's large foreign debt is mostly the liability of the public sector. Given the speed at which the deficit has grown, a sharp reversal, concentrating on tough and rapid expenditure cuts, is now in order.

In conjunction with expenditure cuts, moves to increase taxes will be needed. The increases in the value-added tax and changes to personal and corporate taxation announced in the budget are moves in the right direction, but I stress that the authorities will need to be realistic when projecting resulting revenue. The additional tax measures announced in the austerity package will further help to stem the expansion of the fiscal deficit.

On page 7 of the staff report, it is stated that "the fragility inherent in the present situation does not allow much scope for gradualism," and the austerity package seems on the face of it to provide a sharp shock to the economy. Nonetheless, a coherent medium-term strategy of consolidation will be needed if sustained noninflationary growth is to be achieved. It is essential that the authorities plan this medium-term framework for fiscal retrenchment as soon as possible.

In the area of monetary policy, I note that the task of controlling monetary aggregates will be made much easier once the fiscal position is brought under control and monetary financing is abolished. Nevertheless, monetary policy will need to remain tight in the near future if inflationary pressures are to be contained and the exchange rate protected from further large devaluations. With inflation now around 70 percent and set to rise steeply to about 100 percent or more, it is clear that interest rates will need to remain very high.

There is much to do in the area of structural reform. I would single out public sector wage policy and privatization as two key areas for reform.

On wage policy, the staff argues strongly against the indexation of wages using a backward-looking measure of inflation. The authorities should aim to introduce a more flexible wage-determination process as part of an anti-inflationary strategy. The need to contain the wage bill, in the first instance by resisting nominal wage increases, is a key plank in the strategy to turn the public finances around.

On privatization, I welcome the intention expressed by the authorities that the privatization program is to be accelerated. But we have seen ambitious promises on privatization before, and they have failed to be put into action. Even if privatization proceeds as scheduled, care will be needed not to overestimate revenue. Furthermore, it must be recognized that revenue from this source represents one-off gains rather than sustainable income.

The external position may improve following devaluation; but there must be a concern that any gains in competitiveness might be frittered away through further inflation. I am also concerned by the growth in currency substitution--even if it stops short of full dollarization--and I worry that recent turbulence in the market may lead to a further deterioration of the external position. The threats to Turkey are amplified by the fact that reserves have now fallen to just a few weeks of imports. Time will tell whether the authorities' package will succeed in turning the external position around.

Finally, I would appreciate staff comment on the priorities for further actions beyond the austerity package.

Mr. Cailleteau made the following statement:

After several weeks of a foreign exchange crisis, Turkey's Government has announced an austerity package. Actually, as already mentioned by other speakers, this debate on the situation in this country is highly welcome. We have the opportunity to offer, in due time, helpful recommendations to the authorities.

First, what is triggering the present crisis? Obviously, as recalled by the staff, the situation has gradually become dangerous, despite the obvious vitality of the economy. The main causes are the unsustainable imbalances the authorities have not tackled in a timely manner.

In his very accurate statement, Mr. Havrylyshyn presents some paradoxes on the Turkish macroeconomic strategy. I would tend to see more inconsistencies than paradoxes in such a policy, including the inconsistency between a monetary policy trying to secure the financial environment in order to create the conditions for a sustainable level of external financing and a loose fiscal policy unable to restrain the expansion of domestic demand for maintaining a bearable external position; and, the inconsistency between the rising request of external market financing--with the risks associated with a high exposure to international ratings--and the necessity to "fix" household's cash in order to prevent any overheating.

Overall, the main inconsistency is that the Turkish strategy rests on the search for external confidence, while domestic confidence is not secured, as highlighted by the level of currency substitution--85 percent of M2. In fact, the Turkish economy was suffering a very deficient policy mix with the Central Bank maintaining tight monetary conditions in order to stimulate interest-sensitive capital flows, trying to achieve a steady informal but credible crawling peg, and monetizing a noticeable part of the Government's financing needs. The system was founded on the implicit assumption that such a deficient policy mix would not deter external financing from crowding in.

The immediate causes of Turkey's crisis are twofold, but have the same root: the shift in external confidence. The downgrading of Turkey's debt rating by international credit agencies and the concerns about the new orientation of the exchange rate policy have led to a huge depreciation of the lira against the U.S. dollar. This is a textbook example of "speculative attacks and balance of payments crisis."

Second, is the emergency strategy adapted to the situation? Our broad assessment of the very recent and courageous package announced by the authorities is positive. We feel that this program is well targeted and is likely to prevent Turkey from Latin American-style hyperinflation. In such a situation of crisis of confidence, two sets of measures are needed: symbolic measures to stem the crisis and medium-term commitment to restore confidence. I believe that, given the current situation on the market, it was appropriate to let the lira float temporarily, and to decide simultaneously to fix the interest rates at a level adequate to give a strong signal of the authorities' determination to tackle inflation. The two other immediate reactions required by this situation were obviously to stem monetary financing of the budget and to indicate that, as the only choice was to tighten the overall macroeconomic policy, social disruptions should be prevented by setting up a substantial safety net.

In the medium term, it seems to me that a strong commitment by the authorities to restore a sustainable policy mix is imperative. Beyond the necessity of shifting from a backward-looking to a forward-looking indexation and making strong and credible steps in the fiscal consolidation area--without fiscal consolidation there will be no credible strategy--I would like to add a few words on a very important issue: the question of currency substitution which shows the residents' unwillingness to retain their national currency. I have found Appendix III very helpful but somewhat narrowly focused, as the assumption is that the alternative currency is not a "medium of exchange" whereas, in high-inflation countries, the use of foreign currency as a medium of exchange can be seen as the last but not implausible step of the substitution.

Overall, the staff's conclusion is fairly optimistic, as currency substitution may be reversed quickly once the expected relative returns on the alternative currencies are altered.

Unfortunately, the paper--albeit a background paper--does not offer many solutions to help reverse the substitution. Since the liberalization of the capital account, the authors indicate that individual portfolios essentially reflect the opportunity cost of holding alternative currencies--and then take fully into account the rate of depreciation of the lira.

As shown by Calvo and Vegh in a remarkable 1992 Working Paper (WP/92/40), the higher the elasticity of substitution between the two currencies, the larger the shift from foreign to domestic currency as a result of the fall in expected inflation, and thus the higher the increase in the nominal exchange rate. We can then state that a high degree of currency substitution will make the exchange rate significantly volatile and responsive to credibility issues. Therefore, a high degree of currency substitution strengthens the case in favor of fixed exchange rates, particularly if an early deceleration of inflation contributes significantly to the credibility of the stabilization program.

Like Mr. Havrylyshyn, I would appreciate some comments from the staff on exchange rate policy issues, and in particular on the possibility--with the prerequisite of a strong and credible commitment to fiscal consolidation--of moving toward a strategy of a nominal anchor.

The staff representative from the European I Department remarked that, because the austerity package had been announced that week and the staff had learned about the contents of the package only 48 hours earlier, the staff did not wish to make any comment yet on the measures in the package. Although it had a few opinions on those measures, the staff considered that it would be premature, if not irresponsible, to air them without proper discussion with the authorities.

Whether or not the authorities' ambitious targets were feasible was hard to say, but the authorities seemed to be moving in the right direction, the staff representative commented. They were pursuing measures that could form the basis for an economic program.

In reply to Ms. Lissakers's question of whether a primary surplus that the staff had estimated as at least 3 percent of GDP was attainable in order to reduce inflationary expectations, if the adjustment planned for 1994 was of the extent estimated in the original budget, the primary surplus would be of that size, the staff representative noted.

He concurred with Mr. Dorrington's comments on current priorities, and that it was essential that the package have credibility to demonstrate to the public the Government's commitment to the adjustment of the public finances, the staff representative stated. Thus, the first priority for the authorities was to meet their targets through the second quarter and be in a position to announce that they had successfully met their performance criteria at the time that the Prime Minister publicly discussed the program in July 1994.

Responding to those who had questioned the sequencing of monetary and fiscal policy, in particular exchange rate policy, given the current economic instability and the existing imbalances, flexibility in exchange rate management was required, the staff representative considered. At present, moving to an exchange rate anchor would lack credibility and be subject to speculative attacks. However, once credibility had been established and the fiscal situation appeared to be under control, the exchange rate could acquire a stronger role in terms of acting as an anchor.

The possibilities of a move to a fixed exchange rate, to some type of preannounced crawl, or to a diagonal band had yet to be examined, but could be considered as a next stage after the consolidation of the fiscal position, the staff representative noted.

He agreed fully with Mr. Cailleteau that there was a high degree of substitution between foreign currency and Turkish lira deposits, strengthening the case for a quick move toward a nominal exchange rate anchor, the staff representative continued.

On the role of the World Bank in the privatization process, a $100 million project designed to assist in retraining and relocating displaced workers was ready for consideration by the Bank's Executive Board, the staff representative remarked. The authorities' concern about having a safety net in place was one of the reasons that privatization had been delayed. One possible safety net measure was an unemployment compensation scheme, which would take time to organize; payments could not be made for another two or three years. In the meantime, the authorities were considering using 15 percent of the privatization proceeds to pay rather generous severance benefits.

Central bank advances in the financing of the public sector were, in fact, straight monetization of the deficit, the staff representative observed, and as such, they would have the same effect as monetization of the deficit on the economy and on inflation. The first step to correct the problem of monetization was to cut the deficit by reducing the public sector borrowing requirement. The remainder of the deficit should be financed in the market, and interest rates would reflect that financing.

Ms. Lissakers considered that another visit to Turkey by the staff later in the year would be in order, and wondered whether the staff could prepare a report for the Board on its findings.

The staff representative from the European I Department said that a report would be made to the Directors on the staff visit.

Mr. Havrylyshyn commented that now that the austerity package had been announced, the issue of whether the targets were overly ambitious was a moot one. The main consideration was to adhere strictly to those targets. He was concerned that the measures proposed were the right ones and sufficient to achieve the targets. If the measures fell short in some respect, the only way to regain confidence would be to modify and strengthen them.

The staff representative from the European I Department considered that, as he had noted earlier, the measures were in the right area. The authorities' emphasis on fiscal adjustment was indeed required. On the one hand, as the staff report made clear, the staff would have preferred that issues such as tax exemptions in general, tax expenditures, and the agricultural price support system be addressed at an earlier point; however, the authorities had listed them among the measures to be considered in the medium term--later on in the year. On the other hand, the authorities' public commitment to the austerity package and the fact that they had set up performance criteria themselves on which they were obliged to report publicly at the end of the quarter were important steps. If the austerity program began to go off course, that commitment alone would force the authorities to take additional measures.

The staff was concerned, the staff representative continued, that it would be difficult to quantify the underlying disequilibria inherited from the first quarter, such as how much liquidity overhang was in the system and how much the price structure of public enterprises had eroded. Thus, the degree to which the present price adjustments had compensated for that erosion could not be determined yet.

Mr. Mohammed made the following statement:

> Economic developments in Turkey during 1993 gave rise to serious concerns that were expressed by Executive Directors in

the last Article IV consultation discussions. Since then, macroeconomic imbalances not only persisted but in most areas have grown even more worrisome.

While economic activity in 1993 was brisk, it was accompanied by deeply ingrained inflationary pressures, as well as a marked deterioration in the balance of payments. Foreign financing concerns are clearly emerging and, undoubtedly, if present policies are continued the robust economic activity of last year cannot continue. What is clearly and urgently needed is a radical change in the direction of economic policy aimed at restoring macroeconomic balance and establishing credibility both domestically and internationally.

Looking at the remainder of 1994 and beyond, we agree with the staff in stressing that fiscal consolidation must be the centerpiece of an up-front stabilization package with the aim of putting the economy on the path of low-inflationary and thus sustainable growth. Failure to address the country's fiscal imbalances in a concerted effort runs the risk of jeopardizing economic stability as a whole.

As suggested by the staff, fiscal consolidation must be comprehensive and must critically examine virtually every aspect of public sector activities. While welcoming the authorities' intention to step up the privatization of state economic enterprises, we concur with the staff in cautioning the authorities against interpreting nonrecurring privatization proceeds as a lasting solution to the Government's fiscal problems. Instead, every effort should be made to enhance recurrent tax revenues. Reducing or eliminating the excessive system of tax exemptions and fiscal incentives would be an important first step in this respect.

On the expenditure side, public sector wages must be brought under control. We recognize that trying to alter an entrenched system of backward indexed wages is a politically sensitive matter. Nonetheless, given Turkey's deteriorating fiscal position, the authorities might well find addressing the issue of wage indexation as part of a comprehensive stabilization program to bear far better chances of success. This would be all the more so, if the authorities can make it credible to the markets in general and to the Turkish wage earner in particular that they are committed to tight fiscal discipline with the aim of attacking inflation at its roots. Also, social safety expenditures need to be more carefully targeted and subsidies better monitored, particularly in the agricultural sector, and, wherever possible, phased out.

Turning to monetary policy, the ability of the Central Bank to reduce the persistently high rate of inflation and to reverse the trends of currency substitution and disintermediation are extremely limited, as long as the large fiscal imbalances remain unaddressed. Under such circumstances, a return to what the monetary authorities had been practicing prior to 1993 would be, as noted by the staff, unavoidable. However, this policy has already proved unsustainable, and we fear it might not be a solution at all. The inescapable conclusion is that the budget must be addressed without delay.

We are therefore encouraged to read in Mr. Kiekens's useful statement that the authorities are heeding the warnings emanating from the troubled financial and foreign exchange markets and have decided to act on the staff's advice. We hope that the economic package announced early this week by Prime Minister Çiller is indeed an acknowledgement that fiscal adjustment will be given absolute priority, and we wish the authorities well in the implementation of these long-overdue reforms.

Mr. Giulimondi made the following statement:

The sharp contrast between the aggressive performance of activity growth and deepening macroeconomic imbalances--namely widening fiscal deficit and chronic high inflation--during the past years in Turkey have been vividly depicted, particularly in the statement by Mr. Havrylyshyn. On the occasion of the 1992 Article IV consultation, Directors expressed serious concern about the imbalances that are implied by such a model of development.

Now the picture is darkening, because the external position is rapidly deteriorating--as expected in the event of delayed fiscal adjustment--and growth is slackening, mainly because of the existence of bottlenecks relating to high capacity utilization, rather than effective government control of the economy. The strong devaluation of the Turkish lira, which fell first by 28 percent and then by a further 19 percent against the U.S. dollar in the wake of the very recent announcement of the stabilization program on April 5, may be read as an acknowledgement of the seriousness of the situation and a distrusting reaction of the market to the Government's perceived ability to implement the measures.

In fact, the fiscal deficit in 1993 exceeded 17 percent of GDP, far above the programmed governmental target of 9.5 percent. The fact that the size of the public sector borrowing requirement expected for 1994 is still very high in any case, totaling some 14 percent of GDP, coupled with the poor performance in this area during previous programs, calls one's attention to the extremely narrow margin of maneuverability still remaining and to the risks concerning a further slippage in the implementation of a bold and determined fiscal consolidation. The special weakness of the external position has been already emphasized, as well as the concrete possibility that private investors might be no longer available to finance fiscal imbalances; the recent behavior of the exchange rate seems to me an apparent sign of such a loss of confidence.

In the present circumstance, a further incentive to pursue a sizable and stable adjustment is suggested by the devaluations themselves, which--once the fiscal correction and monetary measures envisaged by the austerity plan are taking place--may finally result in real depreciation, as an opportunity to be seized in order to fully exploit the relevant gain in competitiveness, especially important in an economy as remarkably outward oriented as the Turkish one.

I would touch upon an issue on the fringe of the stabilization plan, that is, privatization. Its role might run the risk of being overestimated in the context of the adjustment efforts. Financial contribution from the privatization plan to fiscal consolidation is to be seen in a medium-term perspective: in the short run, the early stages of firms' restructuring will more likely absorb rather than generate resources.

Concluding these brief remarks, I would like to convey the encouragement of this chair to the Turkish Authorities as they firmly pursue the needed adjustment measures. We understand that the political moment is delicate; yet the time has come to show the greatest determination in order to achieve the minimum results necessary to prevent the situation from getting totally out of control, wasting the exceptional economic accomplishments achieved thus far.

Mr. Törnqvist made the following statement:

In recent years, the cocktail of economic policies in Turkey has contained most of the ingredients for an explosive outburst of inflation. Budget deficits have been large and persistent, and, to a large degree, financed through monetization. In the labor market, persistent inflation has fostered a system of backward-looking indexation which, in turn, provides further fuel to the fire of inflation. Simultaneously, the continued good growth performance over a number of years has fostered the illusion that the high inflation somehow can be tolerated. The combination of high inflation and robust growth over a prolonged period may have the appearance of a paradox, as mentioned by Mr. Havrylyshyn, but, in reality, it is just an illusion.

There is nothing exceptional or miraculous about the occasional coexistence of less than prudent policies and robust growth over surprisingly long periods. A comparison of the recent Turkish experience with economic development in some Latin American countries in the late 1970s might be interesting. There were some who saw a "miracle" there, where imprudent policies apparently did not have as dire consequences as normally expected--for some time. But they did, and the following decade--the 1980s--has been known as the lost decade.

However, I think that there is one important difference between the current conditions in Turkey and those that characterized many Latin American countries in the early 1980s. The openness of the Turkish economy will force the authorities to take some action much sooner than would be the case if the domestic economy were more protected and had the option of resorting to protectionist measures. I see no evidence of such measures being taken by Turkey. The openness of the Turkish economy gives me some justification to expect that the current economic crisis will not culminate in a "lost decade" for Turkey. This is confirmed by the newly announced stabilization measures, and I look forward to learning more about the details of the program.

I broadly agree with the staff's analysis and recommendations and the remarks made by other Directors. I would like only to underscore what the staff and several other speakers have already said about the absolute priority that has to be given to containing the public sector deficit, with measures on both the expenditure and revenue sides. With the continuation of the current level of monetized budget deficits, the economy will, in practice, remain without an anchor, no matter what the target is, and no exchange rate or monetary targeting is going to be successful. I would therefore recommend a faster pace of lowering the limit on short-term central bank advances to the Treasury than indicated by the program outlined by the staff. It is not clear to me, however, whether this is a legal limit or merely a target. In any case, I believe that nothing but a legal barrier will suffice.

As to exchange rate policy, when a sufficient balance has been reached, it might be wise to aim for a more stable exchange rate regime, in the context of income policies designed to break down the system of backward-looking indexation in the labor market.

Mr. Wei made the following statement:

We would like to join the previous speakers in commending the authorities for the impressive economic growth over recent years.

The robust performance is largely the result of rapid investment growth and the flexible, export-oriented response of the private sector to the sweeping economic liberalization.

However, we are concerned about the continuous large fiscal imbalance, persistent high inflation, and vulnerable external position which may rekindle macroeconomic instability. As is noted in Mr. Kiekens's very helpful statement, the authorities are aware of this imbalance and expect it to diminish in the medium term through the introduction of a comprehensive set of adjustment measures. Like the staff, we would like to emphasize the importance of the firm implementation of this program in order to ensure sustained growth.

As I agree with the staff's assessment and share most of the previous speakers' concerns, I will concentrate on only a few issues.

The chronically high inflation rate and worsening external position has mainly resulted from the expansionary public sector policies. Although progress was made in reducing the primary deficit in 1993 and further reductions are planned in 1994, given the current inflation rate and external position prospects the authorities are determined to address the issue through the gradualist approach, as indicated in Mr. Kiekens's statement. It is well known that this chair has always been in favor of a gradualist approach with regard to the economic restructuring strategy. When inflation surfaces, however, our own experience has shown that quick and strong action is required. We note that the authorities are working on a medium-term framework for conducting economic policy and encourage them to take strong action in fiscal consolidation and inflation reduction. In addition to measures in expenditure control and tax reform, the authorities have just announced an economic package designed to lower inflation, stabilize the lira, and narrow public deficits.

The large fiscal deficit has severely constrained the ability of the authorities to undertake an independent monetary policy. Focusing on targeting the nominal exchange rate was perhaps the only alternative. However, in view of the fact that the composition of external financing shifted toward short-term credit and portfolio investment, and currency substitution and disintermediation weakened the effectiveness of monetary management, the overall economic situation has became vulnerable. With the announced comprehensive adjustment strategy in place it is expected that the monetary authorities will be able to secure a stable financial environment. It is obvious that the responsibility for fighting inflation cannot rest on monetary policy alone. Nevertheless, in the face of strong domestic demand, a worsening balance of payments, and an unaddressed fiscal imbalance, we agree with the staff that "monetary policy had no choice but to be tight."

We welcome the authorities' firm stand on wage negotiations in the public sector in 1994 and join the staff in strongly encouraging them to move away from the present backward-looking indexation practices. Continued progress in restructuring enterprises is required in pursuing a strict incomes policy. But, as the staff says, a prior demonstration of a credible fiscal adjustment effort is required.

We commend the authorities for continuing the process of simplification and liberalization of the trade regime. A significant reduction of import duties was carried out in 1993 and all remaining discrepancies from the authorities' obligations relating to GATT-bound tariffs are to be removed in 1994. We have no doubt that this will further contribute to the modernization and rapid growth of the economy.

We wish the authorities success in their future endeavors.

Mr. Schoenberg made the following statement:

We fully support the thrust of the staff recommendations. I think it is clear that, notwithstanding its economic achievements in the past, Turkey is on the verge of entering a vicious circle, leading to hyperinflation. Via wage increases in the public sector and higher interest rate payments on the public debt, high inflation rates result in growing public deficits, which are then monetized by the Central Bank, thereby accelerating inflation. The turmoil in the domestic financial markets, the drop in the exchange rate of the lira, and the downgrading of the country's external debt rating are striking demonstrations of that hyperinflation risk.

To avoid the threat of hyperinflation and to preserve the convertibility of the lira, the authorities must tackle the macroeconomic imbalances in the economy much more vigorously and by much more comprehensive adjustment measures than hitherto. That means, above all, as many Directors have stressed, very drastic fiscal consolidation and the relief of the Central Bank from financing budgetary deficits.

Whether or not the economic stabilization program announced on April 5 fully meets these requirements is of less importance, in my view. The more important question is whether the divided coalition Government has the ability to implement the measures, because that would constitute an important element of confidence building on which, if necessary, further measures could be added.

I have two further observations. The first is that the Government's projections regarding the reduction of the quarterly budget deficits are very ambitious but, until first actions are really being taken, these objectives can be considered only as targets. Second, I have the impression that the authorities consider privatization too much as a device for earning short-term revenue. Even if all the public enterprises that presently are sustaining could be sold or closed immediately, the overall budget deficit would not disappear. And, in the short term, the closure of loss-making public enterprises could add to government expenditure. Privatization thus should be considered as a medium-term objective.

Mr. Oya made the following statement:

Although, unfortunately, there has not been an improvement in economic performance since the Article IV consultation discussion last year, I note that the economic growth rate showed a strong increase in 1993, reflecting robust domestic investment and export-oriented response by the private sector.

As regards economic performance, inflation has been chronically high. Imports have increased owing to strong domestic demand, thereby aggravating the external current account. The external current account deficit was financed by a short-term capital inflow, and consequently the external debt has been growing.

On the domestic side, the fiscal deficit increased because of a large slippage on the expenditure side, although revenue has been approximately in line with the budget. In this economic situation, it is gratifying that the authorities have embarked on the preparation of an economic framework from a medium-term perspective. and in this connection, a comprehensive economic policy should be designed, with particular attention paid to expenditure control. I welcome the new initiatives by authorities and expect them to implement the policy with determination.

It is important, when planning what economic measures should be taken, to make a practical and reasonable assessment of the economic outlook. I am concerned that the authorities' assessment is too optimistic, as pointed out by the staff. In any case, it is necessary to make a realistic analysis of present issues, integrate the appropriate assessment in the policy coordination and reflect it in the policy implementation.

As I have little to add to the staff paper, I will make just a few comments for emphasis.

There is no doubt that the reduction of the fiscal deficit is an urgent task. In this connection, priority should be given to expenditure control, especially the reduction of current outlays. It is important to eliminate backward-looking indexation as soon as possible, as pointed out in the staff paper. In this regard, I support the authorities' position of standing firm on public sector wage negotiations in 1994. However, as long as the current present wage indexation exists, a fundamental solution to the containment of wages cannot be attained.

It is also disappointing that little progress has been made since the last consultation discussion on quantifying military expenditure outside the budget. It is important to establish a transparent budget with a view to conducting appropriate fiscal policy. Transfers to public enterprises have a large share of the total expenditure and are expected to increase in 1994. The reduction of transfers needs to be intensified through further privatization in order to contain expenditure.

On monetary policy, because the inflation rate is very high--71 percent in 1993--restrained monetary policy is needed in addition to the strengthening of fiscal policy from a medium-term perspective. In this connection, it is important to keep the growth of monetary aggregates consistent with the inflation target. I support the staff's view that, in particular, credit expansion to the public sector should be restrained.

On the external front, it is of concern that the external debt has been expanding, and in particular that short-term external financing has been increasing. Furthermore, the ratio of external debt to GNP is projected to increase from a medium-term perspective. In this regard, fiscal adjustment has a key role in reducing the debt, as shown in the medium-term scenario. In addition, it is important to change the debt structure to long-maturity debt in light of the increasing debt burden.

The staff representative from the European I Department noted that the lira had depreciated by 19 percent on April 6, 1994, as a result of a substantial lowering of the interbank interest rate following the announcement of reforms. However, following a tightening of interest rate policy today, April 8, 1994, the lira had risen and was at a higher level than it had been on April 5, before the announcement. Thus, the currency appeared to be behaving erratically at the start of the program.

In response to Mr. Törnqvist's question, the legal limit on how much the Central Bank could finance the Government was 15 percent of the budget, the staff representative observed. As the staff considered that limit high, it was imperative that it be brought down quickly, and, even if the deficit could not be brought down quickly enough, access to the Central Bank should be curtailed as much as possible.

He agreed with Mr. Schoenberg that privatization was a medium-term good that should be seen in terms of its overall efficiency effect on the economy, and not as a revenue element, the staff representative concluded. The staff had made that point continuously over the years to the authorities.

Mr. Kiekens made the following concluding statement:

> All the Executive Directors who have participated in this debate have characterized the situation in Turkey as critical, and indicated that action is urgently needed in the area of public finances to bring down the rate of inflation. Directors stressed that the remarkable growth of the Turkish economy during the past decade can indeed only be sustained in an environment of reasonable price stability.
>
> My authorities are fully aware that the fiscal deficits and structural reforms in the public enterprise sector are the most important issues on their agenda. As Mr. Havrylyshyn pointed out, the fiscal deficits have shown a trend of continuous increase in the 1990s. Unless stopped in its tracks, the public sector borrowing requirement, which has already pushed up domestic interest rates and shortened the public debt maturity structure, will set in motion a vicious circle--this was referred to by Mr. Schoenberg--with increasing deficits giving rise to increasing interest payments, thereby themselves creating additional deficits.
>
> High domestic interest rates in past years have also provoked short-term capital inflows and a real appreciation of the lira against foreign currencies, which my authorities estimate at about 22 percent over the past five years just before the turmoil started.
>
> In the same period, real salaries and wages rose by 80 percent for civil servants and by even as much as 150 percent to 200 percent for workers in the public and private sectors.
>
> All these evolutions resulted in a sharp deterioration of the previously acquired highly competitive position of the Turkish economy in the international markets.
>
> Both these domestic and external developments have led my authorities to the conviction that the continued financing of important budgetary deficits in a "high interest/overvalued currency" policy environment, resting upon short-term capital inflows, has reached its limits and is now on an "explosive path," to use Mr. Al-Jasser's words.

My authorities know perfectly well that the present state of the Turkish economy is serious and that, unless they take and implement appropriate measures, a cycle is looming in which hyperinflation and stagnation will coexist. The Turkish Government has therefore decided on a vigorous stabilization program, and there is no doubt that additional measures will be taken, should it become clear that the decided program falls short.

The program is based on two fundamental principles. First, there will be no retreat from the principles of a free market in any sphere of the economy. Hence, it is out of the question to introduce control on foreign capital movements, to block foreign exchange deposits, or to impose a mandatory consolidation of the domestic debt. Second, as a prerequisite for its success, the program will be based on a social consensus among Government, employers, employees, and other segments of society. It is within this framework that the burden of the wage earners will be balanced by additional taxes on other categories of society; and it is in the same context that the Government hopes to achieve a consensus among social partners on wage objectives, as they have already strived to achieve in the past. In an environment of high growth and profitability of private enterprises, this objective could not be attained. As Mr. Mirakhor pointed out, the usefulness of such a social consensus on wage behavior is, in current circumstances, highly obvious.

Let me now give the Board some additional information on the recent fiscal adjustment package and, more precisely, on the balance between revenue-raising and expenditure-reducing measures.

In its supplement to the staff paper, the staff has indicated that the calibration of the new fiscal adjustment package is difficult to discern from the information available. Table 1 in the supplement might convey the impression that two thirds of the fiscal adjustment will be situated on the revenue side, and only one third on the expenditure side, of the budget. In my introductory statement, I indicated, however, that the new package, contrary to the measures decided on earlier in the context of the original 1994 budget, is tilted much more toward expenditure reduction than toward revenue raising. This apparent contradiction easily can be explained if we recall that Table 1 of the supplement consolidates both the fiscal measures decided on earlier in 1994 and those announced three days ago. In this respect, it is true that, on the whole, the fiscal adjustment effort in 1994 will be carried more on the revenue-raising side. This is because my authorities feel that ample room exists to increase revenues. I would like to point out, nevertheless, that, for the second quarter budget of this year, a deficit reduction of some LT 38 trillion is projected, LT 16 trillion of which relates to revenue-enhancing measures and LT 22 trillion to expenditure cuts. I would also like to point out that Table 1 in the supplement indicates that no additional impact in nominal terms is expected in the area of personnel expenditures. This is true in nominal terms. But by putting a nominal ceiling on the personnel expenditure budget, a sizable cut in real terms will be achieved, which certainly represents a major expenditure-reducing effort.

With respect to Mr. Mirakhor's concern about the authorities' decision to close certain state enterprises in the absence of an adequate and well-funded social safety net, I can provide the Board with the following information. The Government is in the course of preparing an unemployment insurance law that should take effect in 1995. As the staff pointed out, until this scheme becomes fully operational, after two or three years, 15 percent of privatization revenue will be used to finance severance payments to workers. The Government is confident that a loan of $100 million from the World Bank for the retraining and relocation of laid-off workers will soon be obtained.

Mr. Mirakhor and Mr. Cailleteau also wondered if Turkey might not benefit from a more stable exchange rate regime, with the exchange rate providing a full or at least a "dragging" anchor. In this respect, I tend to agree that the adoption of a more stable exchange rate, at an appropriate level, would act as a powerful constraint against further policy slippages, as well as stem the tide of currency substitution. Such decisive steps in the direction of nominal exchange rate stability would require, however, that fiscal rehabilitation be well under way and have reached a degree of credibility necessary to build up confidence in the markets. On this matter, our views coincide with those of the staff.

Let me say, in conclusion, that my authorities have highly appreciated their continuous dialogue with the Fund on policy options that can deliver sustainable growth. They have, therefore, found it particularly useful to have a Board consultation today, at this difficult juncture for the Turkish economy, a point which was also stressed by Ms. Lissakers. Some Directors have felt unable, at this stage, to assess in full the new stabilization measures announced by my authorities a couple of days ago, and this is quite understandable. The staff has made a commendable effort to provide a detailed but necessarily preliminary assessment. Let me add that Prime Minister Çiller will come to Washington next week to explain personally to the Managing Director, as well as to Mr. Preston, the President of the World Bank, the full extent of the adjustment package announced on April 5.

I will not fail, of course, to convey to the Prime Minister, as well as to all other economic policymakers in Turkey, the comments, suggestions, and advice that my colleagues around this table have given me today. I want to assure you all that my authorities have a very high esteem for the Bretton Woods institutions and that they are grateful for the strong support for this ambitious program, that has been expressed by several Directors, and for all the assistance that the Fund and the Bank are able to deliver--and have delivered in the past--to keep Turkey on a path of sustainable growth.

The Acting Chairman made the following summing up:

Executive Directors agreed that the successful introduction of market-oriented reforms in Turkey since the mid-1980s had contributed to impressive results in terms of economic growth. However, they observed that macroeconomic imbalances had increased, reflecting primarily a worsening fiscal situation. They noted that in 1993--and despite continued strong growth of GNP--Turkey's economic performance had seriously deteriorated, with persistently high inflation being compounded by a sharp widening of the external current account deficit. Developments since the consultation discussions, including the considerable pressure on the lira during the first quarter of 1994, heightened concerns about the precariousness of the economic situation. As a result, a comprehensive reorientation of economic policy, led by a durable fiscal retrenchment, had now become urgent in order to restore macroeconomic balance, avoid slipping into hyperinflation, and establish a basis for sustained noninflationary growth.

Thus, Directors welcomed the introduction in the current week of a package of measures to deal with the situation. In particular, they supported the emphasis given in the package to a pronounced strengthening of the fiscal position. Directors expressed the hope that the measures would prove commensurate with the required adjustment, and that the authorities would stand ready to take additional measures if the situation demanded them. Directors also welcomed the fact that the Turkish authorities had avoided measures that would have interfered with the progress made in financial market liberalization.

The importance attached by Directors to intensifying the efforts in the fiscal area was heightened by their view that the fiscal initiatives originally proposed in 1994 would have been insufficient to prevent inflation from accelerating or to help close the external gap. In that regard, Directors shared the staff's concerns about the feasibility of the targets included in the budget for 1994. Thus, Directors welcomed the adoption of much more ambitious fiscal targets, and urged the authorities to take all the measures required to achieve them. Directors emphasized that the authorities' credibility depended on the implementation of those measures--the time for gradualism had passed.

Directors stressed the importance of articulating the fiscal adjustment effort in the context of a medium-term program. In that regard, they welcomed the recent reform of the tax system and urged the authorities to push ahead expeditiously with the privatization program. The latter needed to be supported by further progress in enterprise restructuring and in developing a well-targeted social safety net. The authorities were also cautioned about using privatization revenues as a short-run method of reducing the budget deficit. These broad efforts should also be accompanied by measures to restore the financial health of the social security system, and should include a critical examination of the continued need for fiscal incentives and other subsidies. Directors emphasized the need to reformulate the public sector's wage policy in a way that avoided backward-looking indexation practices.

Directors were concerned about the easing of monetary conditions during 1993, which had resulted from pressures to lower interest rates and from continued financing of the fiscal deficit. They observed that monetary conditions would need to be kept tight until progress in fiscal consolidation was established, taking into account in particular the current circumstances of exchange market turmoil and strong growth of domestic demand. With respect to the exchange markets, Directors noted that the recent depreciation of the lira had addressed emerging concerns regarding external competitiveness. At the same time, it was important not to allow the exchange rate to fall too far, as that could undermine the nominal framework underpinning the authorities' stabilization plan. Accordingly, interest rates needed to be kept high in order to check inflationary expectations and arrest currency substitution. In the future, it would be desirable to explore how exchange rate policy could be integrated, together with fiscal retrenchment, into an overall effort for reducing inflation.

Directors stressed that, over the longer term, external competitiveness could only be durably ensured by fiscal retrenchment, disinflation, and structural reforms, notably in the state enterprise sector. They strongly welcomed the authorities' announced intentions to limit the Treasury's direct recourse to the Central Bank. Directors also commended the authorities' commitment to the liberalization of the trade system.

Directors emphasized that Turkey's current situation was critical and would require a steady implementation of the measures in the recently introduced package, and a reinforcement of that package with a broader-based program of fiscal adjustment and further structural measures.

It is expected that the next Article IV consultation with Turkey will be held on the standard 12-month cycle. Directors encouraged the staff to work with the authorities in the interim period.

6. UNAUTHORIZED DISCLOSURE OF INFORMATION

The Executive Directors discussed recent unauthorized disclosures relating to a Fund document and the results of recent investigations into the handling of confidential Fund documents by institutions, authorities, and Executive Directors.

Mr. Dorrington brought to the Board's attention the fact that the first two items in the Morning Press of April 7, 1994 had reported on the World Economic Outlook and the discussion on the SDR; neither subject had been released to the public. That incident served as a reminder that, following earlier leaks, the Secretary and Mr. Kafka had initiated parallel investigations. He considered that the results of those investigations and any measures that had been taken following those investigations should be reported to the Board, and that a discussion on any further measures would be useful. He suggested that the issue be put on the agenda for a future meeting.

The Acting Chairman agreed.

Mr. Kafka remarked that the issue of further discussion of leaks was in the hands of the Directors. He noted that his investigation had had disappointing results. Only four replies to the questionnaire sent out on April 6, 1993 had been received. He had been quite proud of that result until he discovered that one of the replies was from his own office. He had sent a reminder to Directors on May 27, to which he had received no reply whatsoever.

It was unlikely that investigations into leaks of Board discussions would yield practical results, Mr. Kafka continued, and they would probably yield less than investigations into the handling of confidential documents, which had been the topic of his investigation. Nevertheless, he considered that the only alternative available to Directors was to conduct an investigation from time to time in which the guilty ones would fear being found out and, at least, would be embarrassed. At one point, a detective had investigated the staff, which had put the fear of God into it. However, he judged that it was impossible to put the fear of God into Executive Directors.

Ms. Lissakers remarked that, in the issuance of the draft of the world economic outlook paper, the staff had taken extraordinary steps to keep the circulation confidential, such as restricting the number of copies available, numbering the copies, and forbidding duplication of the document--to the point that her authorities had been constrained to give access to those in the Government who would help to review and comment on the paper. The staff's efforts and the prompt reporting of the paper's summary in the wire services suggested that the staff's efforts were futile. As she represented a government that periodically experienced bouts of leak hunting, with considerably more damage from those than from the leaks themselves in most cases, in contrast to Mr. Dorrington, her concern was that time would be wasted on the issue. She hoped that the staff and the Executive Directors would respect the need for confidentiality and careful treatment of documents, but not be overly concerned if that need was not always observed.

The Secretary noted that, following the leak of December 1992, a questionnaire had been transmitted through the Executive Directors to their authorities on their security arrangements, not only on the leaked document, but also on other papers, in particular the world economic outlook reports. A similar questionnaire was sent to other international institutions receiving Fund documents and to the Fund staff. One third of the member countries had replied to the questionnaire; the responses had not brought the staff any closer to the source of the leak, but they indicated clearly that members had chosen a variety of arrangements for handling confidential Fund documents.

Mr. Dorrington said that, although he appreciated Ms. Lissakers's remarks that leak inquiries were very rarely successful, and he was astounded at the Directors' lack of response to Mr. Kafka's inquiry, the importance of an inquiry's success had to be balanced by the significance of the subject matter--and he considered that it was extremely important. For that reason, he was reluctant to conclude that nothing at all could be done. He agreed with Mr. Kafka that the most serious leaks were those on Board discussions. Indeed, the leak on the SDR discussion appeared to have been made by someone who was very well informed about it, which limited the number of people who could have been responsible for it.

Mr. Schoenberg remarked that he concurred with Ms. Lissakers that hunts for leaks were rarely successful. However, he also agreed with Mr. Dorrington that the Board could not merely ignore what was happening, although he was not sure what could be done.

The Acting Chairman noted that the Board would return to the issue of unauthorized disclosures of information at another time.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/31 (4/6/94) and EBM/94/32 (4/8/94).

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 93/150, 93/151, and 93/161 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/94/45, Supplement 1 (4/6/94) and EBAM/94/49 (4/6/94) is approved.

APPROVAL: November 7, 1994

LEO VAN HOUTVEN
Secretary