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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/98

10:00 a.m., October 30, 1996

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
A. D. Ouattara, Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
M.-A. Autheman	P.M. Fremann, Temporary
	J. Guzmán-Calafell, Temporary
I.D. Clark	C.X. O'Loghlin
	D.Z. Guti
	W.-D. Donecker
H. Evans	J. Shields
	N. Coumbis
	J.C. Martinez Oliva, Temporary
J.E. Ismael	L.M. Cheong
	K. Sundara, Temporary
D. Kaeser	K.M. Heinonen, Temporary
	H. Kaufmann, Temporary
A. Kafka	A.L. Coronel
	J. Prader
	J. Jonáš, Temporary
Y.-M. T. Koissy	H.A. Barro Chambrier
	K. Kpetigo, Temporary
K. Lissakers	B.S. Newman
	M. Daïri
C. Saito	A.G. Zoccali
	S.S. Farid, Temporary
	W.F. Abdelati, Temporary
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	K.M. Heinonen, Temporary
	B.M. Lvin, Temporary
E.L. Waterman	J.-H. Kang
	L.B.J. van Geest, Temporary
	A. Levy, Temporary
	Han M.

R.H. Munzberg, Associate Secretary
W.S. Tseng, Acting Secretary
D.J. de Vos, Assistant
S. Bhatia, Assistant

Also Present

IBRD: P. Levy, Latin America and the Caribbean Regional Office. African Department: K.-W. Reichel. European I Department: M. Russo, Director. External Relations Department: S.J. Anjaria, Director; P. C. Hole, Deputy Director; F. Baker Meio, D.R. Hawley. Fiscal Affairs Department: G.T. Abed, J.A. Schiff. Legal Department: H. Elizalde, H.V. Morais. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; H.W. Bredenkamp, B. Christensen, L.D. Dicks-Mireaux, P.F. Gruenwald, O. Havrylyshyn, S. Schadler. Secretary's Department: R.S. Franklin, B.R. Hughes, M.J. Miller, K.P. Moran, M.J. Papin, S.L. Yeager. Southeast Asia and Pacific Department: A. Singh, Deputy Director; J. Hicklin, M.R. Kelly. Treasurer's Department: A.W. Lake, S.T. Lurie. Western Hemisphere Department: C.M. Loser, Director; E. Canonero, J.P. Guzman, E.S. Kreis, A.S. Linde, A. Quintero, T.M. Reichmann, B.M. Traa. Office of the Managing Director: S. Sugisaki, Special Advisor; J.A. Quick, Personal Assistant; Office of Budget and Planning: N. Kapur; Office of Internal Audit and Inspection: E. Brau, Director; A. Coune, A.J. Doughty, F.P. Mongelli. Advisors to Executive Directors: M.A. Ahmed, M.B. Alemán, M. Askari-Rankouhi, R.F. Cippa, K. Gaspard, A. Guennewich, A.R. Ismael, J. Justiniano, R. Kannan, B. Konan, J. Leiva, M.F. Melhem, S. N'guiamba, J.-C. Obame, T. Turner-Huggins. Assistants to Executive Directors: J.A. Akhmetova, S. Arifin, N.R.F. Blancher, M.A. Brooke, J.G. Borpujari, E.K. Brownlee, J.A. Costa, C.K. Duenwald, L. Fontaine, A. Galicia-Escotto, C.M. Gonzalez, W.K. Gruber, D.S. Hakura, J. Hamilius, Huang X., M. Kell, T.-M. Kudiwu, J.P. Leijdekker, I. Moon, Ng C.S., A.R. Palmason, S. Rouai, M.W. Ryan, D. Saha, G. Schlitzer, O. Schmalzriedt, S. Simonsen, T. Sitorus, Song J., V. Trivedi, E.L. Zamalloa.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director said that he had recently visited the Economic and Social Research Institute in Ireland to deliver the Third Money and Banking Lecture, "Economic and Monetary Union (EMU): A View From Outside." His key point had been that EMU had become too important for the future of Europe to be allowed to fail. In line with several recent staff papers—including for the Article IV consultation with France—he had argued that the costs of the economic slowdowns associated with the fiscal tightening to meet the EMU criteria in 1997 would not be large, provided that authorities did not attempt to reduce inflation further. He had emphasized the importance of the further development of adjustment mechanisms, including in the areas of fiscal policy, labor mobility, and wage and price flexibility to ensure the smooth functioning of EMU. His comments had been well received; the majority of people in Ireland favored joining EMU, although some observers had said that Ireland should not join before the United Kingdom did, for fear that movements in the punt-sterling exchange rate would disrupt the Irish economy.

At the suggestion of the External Relations Department, he had also met with a number of representatives of nongovernmental organizations, including from Ireland's Debt and Development Coalition and Oxfam. They had told him, sometimes inconsistently, that the HIPC Initiative was too little, too late; that HIPC Initiative funds should be additional only; that ESAF conditionality was inappropriate; that the Fund should establish an environment department and not rely on World Bank assessments, because conditionality on the environment was critical; and that the Fund should insist that it would only agree on programs with members that had widespread participatory decision making in the making of programs. The discussion had not been overly informative, for either himself or the nongovernmental organizations. He had thought that they would discuss the issues in depth, to uncover points on which they disagreed, but he had received too many different responses for that to have been possible. He had reiterated, after a useful conversation with Mr. O'Loghlin, that it was inconsistent for the nongovernmental organizations to ask the Fund to expand funding of the HIPC Initiative while they opposed Ireland's contributing to the ESAF, which had made them somewhat uneasy, along with the fact that several poorer countries than Ireland had contributed to the ESAF. In any event, it was important for management to continue its dialogue with nongovernmental organizations, even if neither side changed their minds as a result of the discussions.

2. ARGENTINA—1996 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT—REVIEW, WAIVER, AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered the staff report for the 1996 Article IV consultation with Argentina, the first review under the 21-month Stand-By Arrangement for Argentina approved on April 12, 1996, and Argentina's request for a waiver and modification of performance criteria (EBS/96/161, 10/9/96). They also had before them the authorities' letter of intent (EBS/96/150, 9/17/96) and a background paper on selected issues in Argentina and statistical appendix (SM/96/259, 10/16/96; and Cor. 1, 10/24/96).

Mr. Zoccali made the following statement:

Argentina's economic program, predicated on explicit rules under a currency board arrangement and an extensive array of structural reforms, has proved its resilience in the face of significant shocks both in the economic and the political spheres. Five years and a half have passed since my authorities eliminated widespread indexation, anchored the currency to the US dollar and embarked on a process of unprecedented liberalization and deregulation of its economy, including most noticeably the privatization of most of its public enterprises. The conditions for domestic markets to function more efficiently in a stable, bi-monetary, environment can thus be said to have been laid

My authorities are grateful to the Fund for having supported this process from the beginning and are steadfastly maintaining the overall orientation of policies despite of severe tests. The front-loading of corrective fiscal measures and the reinvigoration of pending structural reforms evidence my authorities' commitment to the program with the Fund. The program modification requested as a result of recent slippages was to a large extent related to the longer than expected duration and more intense slowdown of the economy affecting revenues. At the same time, it is clear that not enough time has elapsed for the widespread structural reforms already implemented to fully take hold. The continued support of the Fund still remains essential to underpin Argentina's macroeconomic stability and sustain the new wave of reforms envisaged in the areas of labor market, health care, federal and provincial governments, and tax and customs administrations. It remains my authorities's expectation that such close collaboration would evolve into a new EFF arrangement as the present Stand-By matures. Their commitment to the market-based policy orientation should be assessed in light of the principle that good economics is also good politics, keeping in mind that they have not refrained from taking the hard measures deemed necessary even in the run-up to elections.

Economic activity is now firmly recovering. Second quarter growth of 2.6 percent was export and investment-led, with orders for capital goods increasing by 27.7 percent with respect to the same period of last year. Preliminary third quarter figures confirm this trend. Industrial production in the third quarter was some 10 percent higher than in the corresponding period of 1995. The economy as a whole is projected to grow at a 6 percent clip during the rest of the year under conditions of virtual consumer price stability. This favorable turn of events comes after four consecutive quarters of negative growth through the first quarter of this year when real GDP contracted by minus 3 percent vis-à-vis the same period of 1995. The performance of the first quarter was responsible for the negative 0.6 percent growth rate of the first semester as a whole.

The weaker than expected recovery in private expenditure, particularly on consumption goods during the first half of 1996 undoubtedly had a bearing on the lackluster performance of the fiscal accounts, particularly on revenue collection which largely explain the slippages vis-à-vis the program. While the delays in eliminating exemptions for the value-added tax and in improving tax administration highlighted by staff were key determinants of the revenue shortfall, those developments cannot be entirely separated from the sluggishness of the first semester. Market sentiment undoubtedly was influenced by the acute contraction of activity of 4.6 percent in 1995. Its persistence through the first quarter in turn increased doubts as to the timing and strength of the recovery. In the circumstances described above, my authorities were confronted with the very real prospect of further delaying the recovery if the fiscal stance was tightened too much. In sum, the magnitude of the cyclical downturn was such that, despite slippages, the fiscal impulse remained negative in 1995 and neutral in 1996.

My authorities are aware that as economic activity strengthens, it becomes imperative to reduce the fiscal gap as quickly as possible, while avoiding an excessively contractive fiscal impulse that could derail the recovery. The new economic team that took office in late July launched a package of fiscal measures, which received Congressional approval by end-September, earlier than expected. Keeping in mind the causes of the recent fiscal slippage, the new package gave greater emphasis to revenue-enhancing measures, including higher taxes on fuels. Nevertheless, these were also accompanied by important expenditure-reduction measures, such as the removal of subsidies for domestic producers of capital goods, the curtailment of outlays on family allowances supplements and the lowering of tax rebates for exporters. To ensure efficacy, these fiscal measures are being supported by a revamping of the tax and customs administrations, a major effort to achieve greater efficiency in the administration of social programs, and by a freeze of nominal discretionary expenditure of the Federal government.

This front-loaded package should contribute to a drastic reduction in the fiscal deficit for 1997 to 1.0 percent of GDP, clearing the way for a balanced budget of the federal government by 1998/9. A budget proposal for 1997 incorporating these elements has already been sent to Congress, together with legislation authorizing higher fines and tougher penalties for tax evasion. The new budget projections are deemed realistic in view of the regained discipline over discretionary expenditure, partly as a result of improved budgetary and financial management practices which served to maintain the trend decline in expenditure since 1994, and conservative revenue estimates which make no allowance for gains from improved tax administration.

My authorities remain keen to reduce the fiscal deficit in the short-term through improved tax administration. In this regard, they have in recent weeks inter alia simplified customs procedures and privatized the valuation function, authorized private agencies to collect tax arrears in cases not exceeding Arg $50,000, introduced summary collection proceedings for tax arrears of up to Arg $1,000, and will shortly put in place a more stringent system of control over value-added tax invoicing, which includes fines on consumers that fail to request sales receipts. They also aspire to consolidate in the future a less distortionary tax structure keeping in mind the still high level of social security contributions that creates a bias against the utilization of labor and the 21 percent value-added tax rate that negatively impinges on compliance. In the medium-term, the tax system will be reassessed in light of international standards and experiences, with a view to its simplification to reduce the costs of compliance and broaden the tax base particularly in regard to personal income. This comprehensive strategy will help to offset the impact of the reduction to date in employers' social security contributions, which staff characterizes as increasing the structural deficit and it is expected to make room for further reductions in the future.

The reform of the pension system of 1994, while affecting the fiscal balance in the short run, implies a profound structural transformation of the budget that will help to strengthen the nation's finances by eliminating an intertemporal gap and by providing a greater scope and depth to the domestic capital market. Privately administered pension funds already reached some Arg $4 billion at end-July and are expected to increase to about $20 billion by the end of the decade reducing, in turn, Argentina's dependance on external capital.

Finally, on fiscal issues, the progress evidenced by the provincial finances in the current year deserves to be highlighted since it practically offsets the overrun in the deficit of the federal government, and serves to maintain the overall deficit of the public sector at a level similar to the 1995.

The Argentine banking system is today basically sound, after having overcome a crisis of confidence which resulted in the withdrawal of almost 20 percent of deposits in less than 3 months in early 1995. An accelerated restructuring of the banking system followed the flight to quality and produced a higher concentration of deposits and loans and fewer but stronger banks. As importantly, the liquidity needs of the system were met without violating the convertibility rule, through active management of initially very high reserve requirements, which along with a restructuring process largely based on market incentives, explains the relatively limited fiscal impact that the crisis had. As the situation improved, the central bank returned to its longstanding policy of stringent liquidity and capital-adequacy requirements. The change-over to remunerated liquidity requirements removed the quasi-fiscal burden on the banks. This facilitated their maintenance at relatively high levels and their extension to all bank liabilities. At the same time, minimum capital requirements for banks operating in Argentina remain well above international standards, without excessive compliance costs as ratios substantially exceed the requirements. The soundness of the system should be further strengthened with the introduction last September of provisioning criteria for market risk.

This prudent attitude toward banking regulations is a by-product of the currency board arrangement which sets clear limits on the central bank's ability to act as a lender of last resort, thereby enhancing market discipline. Nevertheless, my authorities have also sought to put in place new mechanisms to allow the system to better withstand future episodes of excessive market volatility. First, a deposit insurance scheme, fully funded by the banks has been in place for more than a year. More recently, a medium-term swap arrangement has been agreed with major international commercial banks providing, in case of need, liquidity for the pooled holdings of dollar-denominated government securities of the banking system. The amount agreed of the new facility is equivalent to 10 percent of total deposits and could be drawn down by the Central Bank at a pre-specified interest rate not exceeding 250 basis points over LIBOR. The central bank could make these resources available to domestic banks on similar terms. In this way, a privately funded lender of last resort scheme will soon be operational which, together with the existing liquidity requirement, will cover almost 30 percent of total domestic deposits and give confidence regarding the sustainability of the current convertibility arrangement. It should not come as a surprise, therefore, that bank deposits now significantly exceed the pre-crisis level, that the differential between the peso and dollar deposit rate remains low, that the spread between domestic and international interest rates have declined by a further 300 basis points since December 1995 and that long-term mortgage financing in domestic currency is once again available.

The still low level of monetization in the economy and the deterioration in the quality of bank portfolios in 1995, with nonperforming loans still averaging some 9.8 percent net of provisioning, explains the stickiness of lending spreads. The ensuing recovery, the openness of the Argentine financial market to foreign competition, a new credit bureau to reduce informational asymmetries, and the ongoing process of bank restructuring will sooner, rather than later, produce the desired convergence of lending rates.

Argentina's renewed access to international financial markets since mid-1995 has similarly been accompanied by generally improving terms and conditions, i.e., a lengthening of maturities and declining interest spreads on an uncollateralized basis. Particularly noteworthy is the most recent 500 million bond offering in DM, carrying a 30 year maturity, following a successful DM 375 million 20-year bond issue, as part of a diversified debt management program aimed at improving the existing maturity profile of public sector obligations. International investors remain supportive of the present economic program and are exerting a salutary disciplining effect on the policy stance.

To reduce dependance on external financing, however, the government is offering, within a pre-set annual ceiling, short-term debt instruments with a financial structure similar to US Treasury Bills. In this regard, my authorities have purposely limited the amount of short-term debt to be issued to Arg $2 billion, representing a little over 2 percent of gross public indebtedness at end-1996, despite its lower interest cost and oversubscribed demand. This should dispel the notion of a deliberate shift to short-term borrowing and avoid a potential crowding out of private sector operations. In fact, during 1996, private capital inflows were substantially in the form of foreign direct investments and medium- and long-term credits instead of shorter-term portfolio investments. In sum, the sustained expansion of privately administered pension funds and the cautious introduction of new financial instruments are contributing to a deepening of the domestic financial market and, over time, to reduced price volatility.

Regarding Argentina's external sustainability, staff presents a comprehensive analysis of the competitiveness of the economy in Section VII of the Selected Issues paper. It concludes, on the basis of several indicators, as well as productivity gains and cost reduction from the elimination of distortive taxes, deregulation and liberalization, that there has been little if any loss in competitiveness since the peso was anchored to the US dollar in March 1991. The fact that exports have become more diversified in areas of clear competitive advantage such as energy, agricultural manufactures and mining and more than doubled in value terms seem to confirm this conclusion. Moreover, they continue to show rapid growth during the current year notwithstanding the marked slowdown in demand from Brazil, one of Argentina's main trading partners.

My authorities consider that the medium-term projection of 8 percent export volume growth per year constitutes much too conservative a scenario considering the marked expansion of foreign direct investment in several important export-oriented activities, the growth rates in agricultural production and the productivity gains that should result from the additional flexibility of the labor market now under way. In addition, staff's medium-term scenario of total external debt constitutes in my authorities' view a mechanistic interpolation of past trends, as the normalization of prior government arrears has largely concluded thereby resulting in substantially lower issuance of new Bocon debt in 1997/98. My authorities' own projection of total external debt to exports of goods and nonfactor services falls to around 290 by the year 2000. In the event that the output gap is reduced, doubts regarding the external viability of the Argentine economy should become less relevant as relative factor prices continue to improve and the outward orientation of the economy strengthens.

A major social and economic issue in Argentina today is the very high unemployment rate. Section I of the Selected Issues paper attempts to provide some useful insight into this question. Even though the increase in the participation rate may not explain most of the problem, it should also not be dismissed altogether. More than a third of the unemployment at end-1995 could be attributed to the increase in the participation rate since 1991. The conclusion that the main factor impinging on unemployment has been the gains in total factor productivity or the "Solow residual," also tends to oversimplify the problem as this factor embodies a variety of causes, including not only rigidities in the labor market, but also greater competition from trade opening and skill mismatches from the shift to more technologically advanced investment. In this context, merely acting on the rigidities of the labor market may not suffice notwithstanding their importance. More time and an environment of sustained strong growth are also needed.

My authorities are fully aware of the seriousness of high unemployment and remain fully committed to reducing its scope while preserving the overall orientation of economic policy. Many important measures have been introduced in this regard, providing, inter alia, freedom to negotiate labor contracts at the firm level for small- and medium-sized enterprises, temporary employment contracts, generalized reductions in employer social security contribution with additional selective cuts for the young and the long-term unemployed, and more flexible working hours. More recently, major legislation was presented to Congress creating a new regime of severance payments based on individualized contributions administered by the private pension funds, with the aim of reducing the cost to employers while ensuring compensation to workers in case of dismissal or job termination for any other reason. At the same time, social programs to assist those most affected by high unemployment are being reinvigorated through improved targeting and reduction of wasteful outlays in this area. Employment programs that incorporate in-job training for the young are being expanded and incentives for teenagers from poor households to remain in schools are being considered. The second reform of the federal public administration, now in full implementation, is geared to consolidating new efficiency gains and, as importantly, retraining redundant employees, inter alia, through on the job training in private companies funded through the public payroll until their final separation.

The unprecedented scope of recent reforms to the health care system, largely administered by the labor unions and funded through mandatory employee contributions should also be highlighted. Earlier this month, President Menem signed a decree allowing workers to direct individual contributions to the union-run health care organization of their choice while establishing minimum standards of service to improve the quality and the price of health care delivery. The next step, envisaged for 1998, is the complete liberalization of health care services by allowing workers the freedom to contribute to the health care provider of their choice, be it union or privately owned.

In closing, despite a succession of difficult tests and occasional slippages, the Argentine economy has in recent years undergone a dramatic transformation with tangible results in terms of resiliency, stability and transparency. My authorities remain committed to concluding the process of structural reform convinced that this is the only way to underpin macroeconomic stability and to foster sustained and equitable growth commensurate with Argentina's potential.

Mr. Zoccali, extending his remarks, indicated that fiscal revenue in October had increased substantially from September to a level somewhat above the revised program projections, reaching 3.6 billion pesos, or some 10 percent above revenues in October 1995; in addition, the September increase in industrial production had been the largest in one-and-a-half years, with production 11.1 percent above its level in September 1995. To put the revenue shortfall in perspective, GDP in 1996 would be about 2 percent below its level in 1994.

Mr. O'Loghlin made the following statement:

I would like to thank the staff for its thorough and useful analyses in both the staff report and the background document, which have helped to shed light on a number of key issues in the Argentine economy. I am also grateful to Mr. Zoccali for providing clarification of some of the points raised in the staff report.

Argentina missed all six of the end-June 1996 performance criteria. Most notable among these was the shortfall in federal government revenue. It appears that much of this shortfall could have been avoided. I am deeply concerned about the repeated failure of the authorities to adhere to the performance criteria and requests for the modification of some of the targets in every arrangement that they have had with the Fund over the past five years. This case, which is not an isolated one, emphasizes the need for the Board to consider the impact of continuously granting waivers and modifying program targets on the credibility of the Fund arrangements and the integrity of the conditionality of the Fund programs.

However, this chair is willing to give the Argentine authorities the benefit of the doubt one more time and agree to the present request for waiver and modification of performance criteria. This decision is based on the fact that there is a new economic team, which appears to be more committed to reform and has made some progress in increasing the flexibility of labor markets, improving the efficiency of the banking system, and controlling government spending. However, completion of the next Stand-By Arrangement review would be very difficult if the authorities did not fully adhere to the revised performance criteria.

Output growth has resumed following a very deep recession in the aftermath of the 1994 Mexican crisis. Argentina is going through a critical period in its economic development. In terms of business cycle, it is trying to come out of a very deep recession without the ability to use monetary policy. From a longer-term perspective, it is undergoing structural reform that has seen high cost labor replaced by relatively low cost capital, resulting in very high levels of unemployment. We are encouraged by the authorities' efforts to put the proper fundamentals in place despite difficult economic conditions.

The staff projects growth in 1997 of 5 percent. It is unclear, however, what the source of this growth will be. Fiscal policy will remain tight as the fiscal impulse is expected to be negative for the third consecutive year. The external sector is projected to contribute negatively to growth as export volumes increase by 7 percent while import volumes rise by 9 percent. The constraints of the Convertibility Plan make it impossible for the authorities to ease monetary policy independently of the United States, where it is more likely that interest rates will increase in 1997. While unemployment fell slightly, to 17 percent in May 1996, further reductions will likely lag the increase in output. The persistent high level of unemployment does not bode well for consumer confidence and will likely constrain consumer spending. These factors lead me to conclude that there is a significant downside risk to the growth forecast in 1997, which would also put the revenue forecast at risk.

The currency board arrangement in Argentina has disabled a very effective policy instrument. While I can see the rationale for a currency board for an economy in transition from hyperinflation, I do not believe Argentina with its low inflation and substantial progress in structural reform needs to put its macroeconomic policy in a "straightjacket" in order to promote stability and sustained growth. One gets the sense from the staff report that the ultimate objective of government policy in Argentina should be to defend the Convertibility Plan. For example, on page 15, the staff notes that "The authorities need to persevere in their efforts to lower the fiscal deficit to buttress confidence in the Convertibility Plan..." Should the decision to further tighten fiscal policy be made for the sole purpose of maintaining confidence in the Convertibility Plan, or, should it depend on the cyclical position of the economy and the capacity of the government to manage its fiscal affairs effectively?

If a further reduction in the budget deficit were judged to be necessary in its own right, then the authorities should have the option to loosen monetary policy in order to offset the direct contractionary impact of fiscal consolidation on economic activity in the short run, particularly in the current situation where there is a large output gap and no sign of a resurgence in inflationary pressures. However, the Convertibility Plan has denied the authorities this option. I am not advocating an immediate dismantling of the Convertibility Plan in Argentina, but only suggesting that the authorities should keep future exchange rate options open and consider an exit strategy from the currency board arrangement at an appropriate time. Has the staff discussed with the authorities the appropriateness of the Convertibility Plan and the possibility of moving to a more flexible exchange rate system?

On fiscal policy, I concur with the staff that a return to the original fiscal targets would not be appropriate because a tightening of that magnitude would pose a risk to the recovery. A troubling aspect of the fiscal performance is the composition of the shortfall in federal government revenue. Box 1 on page 3 of the staff report shows that between 75 and 80 percent of the revenue shortfall can be explained by unplanned cuts in excise taxes, the failure to widen the base of the value-added tax, and slippages in the value-added tax administration and social security administration. The apparent lack of commitment or ability to collect taxes leads me to question the extent to which the authorities are able to control fiscal policy. It also puts the success of the September 1996 revenue package in doubt. Efforts to strengthen the institutional capacity of the tax agency are encouraging, but there is a risk that the legislation to increase the penalties for tax evasion could be delayed.

I commend the authorities for their efforts to strengthen bank supervision and tighten capital adequacy requirements. I share the authorities' view that enhancing confidence in the financial system is essential to reduce intermediation spreads and help boost private sector investment. I am also encouraged by the staff's report that the problem loan ratio has declined both on a gross basis and net of provisions. With net problem loans at 9 percent of total loans and bank capital at 16 percent of risk-weighted assets, it appears that the banks' financial position may be adequate. Given the emphasis the Executive Board places on the soundness of the banking system in the surveillance exercise, I am disappointed that the staff report did not provide a detailed assessment of the banking system in Argentina.

The authorities appear to be committed to address labor market rigidities, which should be commended. The proposed legislation to increase the flexibility of labor markets and reduce labor costs should be implemented as vigorously as possible. Given that the exchange rate is fixed under the Convertibility Plan, measures to enhance labor productivity are absolutely essential to enhance Argentina's competitiveness.

I am also encouraged by the authorities efforts to reform the health system, intensify privatization, and restructure the delivery of social programs. At 9 percent of GDP, expenditures on social programs are very high and can be reduced through efficiency-enhancing measures without reducing their effectiveness. Could the staff elaborate on the authorities' plans to revamp the delivery of social programs?

Mr. Kaeser made the following statement:

After a year of recession, economic growth has resumed in Argentina. The substantial surplus on the capital account and the increase in private sector deposits in the banking sector indicate a return of confidence in the country's economic prospects. The arrangement for a medium-term line of credit reached with a group of foreign banks will enable the central bank to reduce systemic risk in the banking sector and will further enhance confidence. However, notwithstanding this strengthening of economic activity, all performance criteria for end-June 1996 were missed.

In our view, this development is highly regrettable. One important objective of this Stand-By Arrangement, as in the previous Extended Arrangement, was to improve the fiscal balance. A narrowing fiscal deficit or even a surplus would have reduced Argentina's reliance on international financial markets and its vulnerability to changes in market sentiment. Since 1993, however, the overall balance of the federal government has been continuously deteriorating. Today, even the primary balance is in deficit.

The deviations from the end-June targets were mainly the result of a shortfall in federal government revenue. Several measures seem to have backfired, not having yielded the expected broadening of the tax base. The package of austerity measures approved by the Congress end-September, by increasing a number of tax rates, could be expected to yield better results. However, unless tax administration is improved and the penalty of tax evasion increased, no significant and lasting improvement of the situation should be expected. We therefore welcome the authorities' recent efforts to carry through institutional changes and improve enforcement in order to broaden the tax base and combat evasion more forcefully.

The measures aimed at increasing fiscal revenue will be crucial for achieving a reduction in the budget deficit, since cuts on spending will probably meet growing resistance. The recovery in economic activity has not managed up to now to achieve a significant reduction in the high unemployment rate Argentina is confronted with. As the staff observes, the persistence of this high unemployment is creating considerable tension and could undermine political support for the Convertibility Plan. These tensions could be expected to increase, as spending cuts will mainly fall on social expenditure and as next year's mid-term legislative elections are getting closer.

Social unrest could be further exacerbated by the changes occurring in the financial sector. The concentration of the banking sector has continued. As we feared, there are indications that the closing of small wholesale and cooperative banks has had adverse effects on the supply of credit, particularly in rural areas and small municipalities. As growth picks up, this difference in access to credit may not allow the benefits of recovery to be spread across the country and inequalities in income distribution may increase.

However, we welcome the authorities' efforts to strengthen the banking sector against systemic risk. The adjusted liquidity, as well as capital requirements that take into account market risks of securities, will strengthen the banking sector. In the same vein, as we mentioned above, the arrangement for a medium-term line of credit reached with a group of foreign banks will further enhance confidence.

We would also like to express our support for the authorities' perseverance to undertake politically sensitive structural reforms. The labor market calls for fundamental reform. We hope therefore that the legislation to increase the flexibility of the labor market has been introduced, as envisaged in the program. The health care system is also in need of change. By letting workers choose their union health care fund, competition among health insurance organizations should yield some efficiency gains.

We would appreciate it if the staff could give more information on the structure of the external debt owing to its very high level and the high level of the debt service ratio.

In conclusion, the authorities have managed up to now to regain the confidence of investors and depositors by finding a balance between the restrictive macroeconomic policies required by the Convertibility Plan and the high social costs implied by these policies. The elements mentioned above may indicate that this balance will be increasingly difficult to maintain. As the recent successful issue of Argentina's 10-year global bond would suggest, financial markets seem for the moment confident in the authorities' ability to manage their fiscal position and maintain the Plan. We would therefore agree to support once again Argentina's request for waivers and modification of performance criteria. We would however urge the authorities to achieve their fiscal targets and make progress in their structural reforms, as market sentiment could easily reverse.

Mr. Daïri made the following statement:

The staff report describes Argentina's performance under the stand-by program as "mixed." This is an assessment that one can broadly share. The economy has performed well on a number of fronts: activity has recovered, external trade performance has been satisfactory, a substantial capital reflow is reflecting growing confidence, and inflationary pressures have remained subdued. However, other less propitious developments have tended to detract from these positive accomplishments. Fiscal performance has been off target as a consequence of large shortfalls in government revenues, although Mr. Zoccali asserts us in his statement that the slippage was to a large extent related to the unanticipated duration and intensity of the economic slowdown. Unemployment has been slow in responding to the pickup in activity and remains a source of continuing concern.

The authorities have developed a revised program for 1996–97, which envisages a major fiscal correction and wide-ranging structural reform initiatives. These are welcome steps. The fiscal adjustment is strong and broad-based, and strives to balance the need for a prompt restoration of public finances against the risks of derailing the nascent recovery by an "excessively contractionary fiscal impulse." According to the staff report and the authorities' full recognition, its success will depend crucially on improvements in the tax system and administration where the experience of 1996 demonstrated that much remains to be done despite the considerable progress in recent years. A durable improvement in revenue performance will also pave the way for a reduction in the high rate of wage taxes and value-added tax rates. No less important to achieving fiscal consolidation will be the need to exercise firm control over spending in the remainder of 1996, and beyond. In this regard, the budget proposal for 1997, at present before Congress, calls for no increase in nominal discretionary expenditures from the 1996 level, including effecting savings in the social security system. We join the staff in urging early congressional passage of a budget for 1997 and close monitoring of the path of federal finances in the period ahead, so that emerging slippages could be promptly corrected.

The restructuring of Argentina's banking sector in the aftermath of the 1995 crisis and the improved regulatory framework have helped foster confidence in the banking system and the Convertibility Plan. The planned strengthening of the central bank's free international reserves, together with the creation of a deposit insurance scheme and the negotiation of a medium-term swap arrangement, should go a long way toward enhancing confidence further and reducing country risks. The authorities' caution in dealing with the question of the privatization of the Banco de la Nacion is understandable, given the bank's crucial role in providing credit to farmers and small businesses. This should not, however, detract us from the importance of moving forward with the privatization of banks and public enterprises at the provincial level.

On the structural front, the labor market reform stands out as deserving the highest priority. Passage of the legislation aimed at increasing the flexibility of labor markets through, inter alia, the introduction of a decentralized collective bargaining system, can be expected to make a major contribution to increasing competitiveness and reducing unemployment. The staff's medium-term scenario projects that real GDP growth will accelerate in the near future to above potential (in the 5–6 percent per annum range) before settling down at potential level. It does not indicate how unemployment is expected to respond to the pick up in growth, what benefits the planned reduction in labor taxes, and the introduction of the new legislation in the labor market might have on raising the elasticity of employment with respect to output. The staff may wish to elaborate on this issue. It is clear that evidence of an early breakthrough in reducing unemployment will be crucial to easing tensions and strengthening political support for the Convertibility Plan. In the meantime, we are encouraged by the fact that social programs to assist those most affected by high unemployment are being reinvigorated through better targeting and reduction of wasteful outlays.

In conclusion, the authorities' revised program, if implemented with vigor and determination, should pave the way for an early return to stable financial conditions, foster confidence, and strengthen the foundations for a resumption of strong growth. No doubt, risks remain and the "margin for deviation" is very small, especially in the fiscal area, but also in the pace of implementation of structural reforms. We are encouraged by Mr. Zoccali's statement that his authorities remain committed to concluding the process of structural reforms, which they regard as the only way to underpin macroeconomic stability and foster growth. We support the authorities' intention to work toward a new EFF arrangement with the Fund.

We support the proposed decision.

Mr. Sivaraman made the following statement:

The Argentine authorities deserve our commendation for their commitment to the reform process. The economy is gradually coming out of the recession of 1995. The growth rate has picked up, although low, it is a positive sign. Inflation has been negligible at under 1 percent and the capital outflow has been reversed as well as the access to the international markets eased. These positive signals are, nevertheless, accompanied by some worrisome factors. The unemployment continues to be high at around 17 percent, and the policy credibility which wavered due to a change in the economic management team has picked up slowly. Although the Convertibility Plan has meant an anchor of strength to the economy and has served its purpose satisfactorily the slippages on the fiscal front have been so large that the entire program was jeopardized.

The main areas of my focus would be the fiscal consolidation efforts and the structural reforms. I will limit my statement to these two important issues.

The fiscal effort in Argentina has lagged behind its targets for the last few years. From a reading of the staff papers containing program reviews presented in 1995 and then those presented this year there has been a continuing adjustment of the program targets. And most of them have been done to accommodate a slackening of the activity in the fiscal, monetary and the external sectors. For example the staff papers (EBS/95/51, Supplement 1, dated March 29 1995, EBS/95/150, in September 1995 and EBS/95/211 in December 1995) requested modification in the criteria and waivers and now, the most recent staff paper on the stand by arrangement has asked for modification in the performance criteria with accompanying waivers. As I see, this is certainly not because of any slackness in commitment on the part of authorities, as is evident from the steps taken and policies implemented. I would like to ask the staff if the slippages could have occurred because of the ambitious program targets? By itself, this may not be a bad policy, because if it is successful it can provide the same relief earlier. The problem arises in so far as it alters the perception of the outside world when these targets are missed. The Argentine economy has performed well after the shock of Mexican crisis. As noted already the growth has picked up and inflation is very low, the private credit is picking up and exports have a robust growth. Even the productivity gains have been substantial as have been the gains in reduction of unit labor costs. The expenditure slippage, mostly on account of goods and services, has been from a programmed level 0.6 percent of GDP to an actual level of 0.8 percent of GDP and on revenue side in the privatization revenues have lagged behind the programmed level of 0.4 to 0.2 percent in the January to June period. The net revenue slippage has been only 0.6 percent of GDP. And in view of this, the adjustment proposed is almost one percent of GDP for the entire year. The point is that this slippage may have had an adverse impact on the policy credibility, and it is not surprising to find that a reflection can be found in the high rates of interest rates, both deposit and lending in either currency, that prevailed in end 1995. Although the Argentine authorities need to brace up their revenue efforts, it is not too difficult to see that a realistic fixing of the targets may have helped us avoid this additional effort to adjust them now.

While on the fiscal issues, let me also touch upon the matter of "amnesty scheme" that this chair had tried to focus the attention last time when the Board was discussing the approval of the stand by arrangement. The major revenue short fall has been on account of this scheme. As far as value-added tax is concerned, too many exemptions will eventually show up on the revenue collection. It is indeed difficult to get rid of these exemptions due to deep rooted vested interests. The authorities should try to eliminate the exemptions and widen the tax base for a successful implementation of value-added tax. It goes without saying that all these revenue efforts will bring about a better fiscal balance in the short run, but for the medium term a change in the structure of spending seems absolutely essential. This brings me to the structural issues.

On the structural issues, the social security reforms, the tax system, the provincial finances and privatization are the areas for the authorities to focus upon. All these will directly help the fiscal situation also. Although the authorities are trying their best to implement the reforms in the social security system started in 1994, and the switch over from the pay as you go to the fully funded privately managed system was expected to help ease the burden. In the medium term the fiscal costs of transition are going to continue to be large for some time as more persons switch from the old public scheme to the private scheme. Even within the new privately managed scheme the bigger problem that the authorities need to fix in order to make it work efficiently, contribute to national savings and provide old age insurance, is concerning the compliance rate, which has fallen from 73 percent in 1994 to 55 percent this year. The magnitude of the problem is further enlarged with the takeover of the provincial pension system by the Federal authorities. The authorities have a long agenda of items in the social security reforms needing their urgent attention.

Finally, I concur with the staff report that the margin for error with the Argentine authorities is very narrow and they are encouraged to take necessary steps to continue the pace of reforms and hasten it further. While supporting the proposed decision I also wish the authorities well in their future endeavors.

Mr. Abdelati, speaking on behalf of Mr. Shaalan, made the following statement:

Argentina continues to make progress in overcoming the confidence crisis of early 1995. After the recession bottomed out at the end of 1995, the recovery has gained momentum in the first half of 1996 with a modest but welcome decline in the still very high rate of unemployment. Capital reflows continued and so has access to international markets at lower spreads. It is generally agreed that this resilient recovery underscored the effectiveness of the Convertibility Plan and was aided by Argentina's established track record of structural reforms especially in trade liberalization and privatization.

Notwithstanding these commendable achievements, the economy remains vulnerable to fiscal weaknesses which could endanger the still fragile market confidence and increase the risk to the Convertibility Plan. Although growth is still expected at 2.5 percent in 1996, consistent with program assumptions, there are important shortfalls in program implementation. When the Board approved this program in April, it was noted that recovery and sustained growth in the medium term are contingent on rigorous fiscal consolidation and a renewed push for structural reforms to maintain confidence gains. At that time, I had expressed concern that, even if the authorities implemented all the agreed measures in a timely manner, the fiscal target may not be met if the recovery was delayed. The authorities therefore had very little room to maneuver. In the event, the pace of recovery did not slow down as feared, but rather it is the pace of policy reforms (fiscal and structural) that was delayed. This is a cause for concern.

The fiscal targets were missed by a large margin for end-June 1996 mainly due to shortfalls in government revenue from three sources: unprogrammed excise tax cuts on luxury goods; delays in the implementation of tax enforcement procedures; and over-optimistic revenue estimates (with respect to value-added tax, social security contributions, nontax and capital revenues, and improved compliance in response to the tax amnesty). The revenue shortfall was aggravated by expenditure overruns in a number of areas. As a result, the overall public sector deficit, which was targeted to decline to 1.8 percent in 1996, will now remain at the same level as that of 1995, namely 3.2 percent of GDP before declining in 1997 to 1.6 percent of GDP. If there are repeated revenue shortfalls or expenditure excesses in the coming months, the authorities should be prepared to take corrective measures to ensure compliance with the revised targets. Have the staff discussed with the authorities contingency measures in case of such an eventuality?

Medium-term fiscal sustainability hinges on continued progress in tax administration, pension reform, and provincial finances. Pension reform has been a priority for the government for some time now. The reforms implemented in 1994 went a long way toward placing social security finances on a sustainable financial path and helping to deepen domestic capital markets, although the original reform package was not approved in its entirety. While additional measures are being implemented to improve monitoring and audit procedures, including through the short-run "emergency plan," these are likely to yield only minor adjustments. In addition to strengthening administrative capacity and absorbing provincial pension schemes, longer-term improvements should focus on mandatory inclusion of all new employees into the new system and introducing measures (such as prorating of pension benefits) to encourage participation of noncontributing workers who cannot meet the current minimum contribution criteria of 30 years.

Provincial finance reform is an area that should be accorded high priority. We note that discussions on new revenue-sharing arrangements that were scheduled to be completed by end-1996 have now been extended through 1998. As illustrated in the staff's useful background papers, the current system of revenue-sharing is overly complex and has contributed significantly to fiscal imbalances. Some scheduled simplification measures, such as the elimination of provincial turn-over and stamp tax, will worsen the fiscal position of the provinces in the short run and therefore increase the dependence on transfers from the federal budget. These losses, however, will be offset by fiscal savings in both the short and medium term as 11 provinces transfer their provincial pension funds to the central government. An area where the pace of reform has been more rapid is provincial privatization. Only 15 of the 78 provincial public enterprises, and 10 out of the 27 provincial and municipal banks, remain without a privatization plan. While this is not expected to yield significant privatization proceeds, it will constitute important fiscal savings as these enterprises and banks had become an increasingly large drain for provincial governments. Along with continuing this process of privatization, agreement on revenue-sharing arrangements, reductions in the civil service workforce, and improvements in tax administration would go a long way in bringing provincial finance under control.

In addition to the threat posed to recent gains in market confidence by fiscal weaknesses, the authorities face the challenge of maintaining support for the reforms. Public support will become increasingly difficult to maintain unless more significant strides are taken in reducing the high rate of unemployment. The cuts in social security contribution rates from 50 percent to 39 percent of the wage is a welcome measure to reduce labor costs and boost employment. The proposed Collective Bargaining Law and proposed new regime of severance payments should contribute to increasing flexibility in the labor market in order to maintain competitiveness. But, as Mr. Zoccali pointed out in his Buff, more rapid employment growth requires not only reducing labor market rigidities but also an improved environment of sustained growth—which in turn is based on sustained market confidence.

In view of the corrective measures undertaken by the authorities, their commitment to continuing with their reform program, and readiness to take additional measures, if needed, I support the proposed decision.

The staff representative from the Western Hemisphere Department, responding to a request from Mr. Autheman for clarification on the causes of the fiscal slippages, recalled that when the initial program had been negotiated in February 1996, the authorities had wanted to have more ambitious targets than the staff. The staff, however, had been cautious regarding potential revenues from measures to improve tax administration and to contain social security outlays, and had disagreed with the authorities' more optimistic GDP forecast. Nevertheless, the staff had also been concerned about possible market reactions to the impending fiscal deficit, thinking that confidence might be damaged and that there might not be adequate financing; thus the staff had ended up accepting, in part, the authorities' more ambitious deficit target. The staff's caution had proved to be correct: about 0.5 percent of GDP of the total fiscal shortfall of 1.2 percent of GDP had owed to implementation problems regarding tax administration and social security contributions, although actual GDP growth had been faster than projected.

The Acting Chairman commented that Fund-supported programs in Argentina had not been optimistic in all cases; for example, in 1995 the authorities had well exceeded the yield expected from the tax amnesty. The Fund's relative pessimism in 1995 might well have played a role in its negotiations with Argentina in early 1996, leading it to negotiate a program that might have been optimistic in hindsight—albeit more cautious than the authorities had wished.

Ms. Lissakers made the following statement:

Like others, I am encouraged by the recent signs of recovery in the Argentine economy after the very deep recession it has experienced. I thought it was quite useful for Mr. Zoccali to point out not only the strong improvement in industrial output recently, but also to put recent figures in perspective, for example, of where the Argentine economy is now relative to where it was in 1994. Nevertheless, the signs are encouraging and the pick-up takes place under conditions of relative price stability. The banking system is also clearly in better shape than it was a year ago, and the Argentine authorities have renewed their commitment to proceed with the very broad-based reform effort to restructure the Argentine economy, particularly the operations of the public sector.

Nevertheless, I have two concerns. (I must say as I went back and forth through the background papers and the staff report I came away somewhat troubled and with a lot of questions). One is the question of waivers. Like

Mr. O'Loghlin and others, I am troubled by the repeated requests for waivers, though the staff has to some extent answered my concern. My sense is that we can explain the reasons for each incremental change in adjustment in the target; but if we step back and look at the overall picture, it is troubling, and I am not sure we fully understand why these slippages have occurred.

Mr. O'Loghlin refers to either an apparent lack of commitment or ability to collect taxes. Well, I do think that the authorities in Argentina have demonstrated a very strong determination and commitment to reform throughout a very difficult economic and, indeed, political time. So, one has to ask whether there are other difficulties that underlie these revenue slippages. My question is whether there just is not mounting resistance—and understandable resistance—to paying taxes, given the economic climate and the extraordinarily high rate of unemployment. As we know, when taxpayers want to avoid taxes, they can find ways to do so, and one wonders whether there is not a deepening climate of resistance because of the harsh economic conditions.

There are some other signs of such behavior. I thought the background paper's discussion of what has happened to pension contribution rates highlighted a very worrisome indication of tax avoidance. During the past two years, the contribution rate has declined from 73 percent to 55 percent. Indeed, the contribution rate in the private pension scheme, which one would have expected to be higher, is very low at 50 percent. I would be interested in the staff's interpretation of these numbers. Is it an indication of people, in effect, hoarding their resources because of the difficult economic climate?

Indeed, on page 19 of the background paper, the staff itself raises some questions about the sustainability of the effort to close the revenue gap. It says, "The partial compensations for the increase in the underlying deficit undertaken so far by the authorities, by measures such as raising the value-added tax rate to 21 percent and holding down capital spending, may not be sustainable over the longer run."

Now, the response we have to the slippages built into the program under the government's policies is to broaden the value-added tax rate, to raise excise taxes, to raise corporate and income tax rates. I wonder whether this would not simply increase the resistance to paying taxes and, therefore, not produce the desired revenue result, although admittedly the last month's increase seems to be a hopeful sign. Also, over time, will it weaken the growth impulse? This is a procyclical fiscal policy. The fiscal impulse is going to be negative again over the next few quarters.

Like Mr. O'Loghlin, I am not sure what will sustain the recovery of growth in Argentina. Clearly, there is no room for countercyclical fiscal policy and I am not advocating such a policy option. Argentina's external debt servicing is very high as a percent of exports of goods and services. The current account is expected to widen in the medium-term scenario. And while borrowing costs for Argentina have come down somewhat, it is a very mixed picture. The staff's table, looking at average yield spreads for public sector foreign bond issues, points out that on dollar-denominated issues the yield spread has gone from 291 basis points in the period January-September 1995 to 403 basis points in January-September 1996, and a similar trend of widening yield spreads on the deutsche mark and yen issues as well. I realize that these public sector issues are a mix of public enterprise, provincial and federal government debt. Nevertheless, it is not quite as positive a picture as I would have expected. Private sector issues are being looked on a little more favorably, but borrowing costs are not likely to fall dramatically for Argentina in the near term and foreign direct investment has not been notably strong since the big privatization surge.

In any event, this brings me to my other concern, which is the external competitiveness of the Argentine economy and the exchange rate. There is a long and complex discussion of various measures of competitiveness in the background paper, which concludes that Argentine competitiveness has not declined or has only slightly declined since 1991, given all the structural changes that have been under way and fiscal consolidation, and so on, in Argentina. Frankly, I would have expected a significant improvement in competitiveness, but the fact is that there has been a very strong real appreciation of the peso in this time relative to the U.S. dollar and relative to the European currencies.

The discussion on page 36 of the background paper says that there was apparent erosion of competitiveness between 1991 and 1994, and then a turnaround in most indicators since early 1994. But if one looks at the reasons for this turnaround, it appears largely due to developments in the Brazilian economy rather than Argentina. Also, there is the depreciation of the U.S. dollar vis-à-vis other major currencies. The other measures that have helped to support Argentine exports are the elimination of export duties, and also some productivity gains. But the major factors that the staff points to are external, and one of them—the U.S. dollar—certainly has been reversed in recent months. I would ask the staff to comment on the impact of the stronger dollar on the overall competitiveness of Argentina's exports in the international market.

When one looks at this combination of a negative fiscal impulse on growth and perhaps some erosion of competitiveness in Argentina due to external factors, one has to ask whether growth will really be as projected by the staff and, therefore, whether the fiscal situation will evolve as projected. Again, I point to the statement by the staff on page 19, which deals with the structural deficit and which points out that, "the above analysis does not consider the general equilibrium conditions for sustainable growth and external and internal balance. Indeed, there is no assurance that the elimination of the output gap, i.e., a return to potential growth of 4–5 percent a year, would be consistent with external viability at existing relative factor prices and with the underlying structural fiscal balance." In other words, the analysis leaves unanswered the question whether the underlying fiscal balance is consistent with low unemployment labor market equilibrium at current relative factor prices.

Now, I do not know how to interpret this. Is this simply an explanation of the limitations of this particular model, or is this also, to some extent, an expression of concern by the staff about whether all these pieces fit together?

Mr. Fukushima made the following statement:

I understand that the authorities have been struggling to eliminate the negative side effects of the Mexican crisis, as Mr. Zoccali's helpful statement mentions. It is of great concern, however, that none of the performance criteria for end-June were observed. With regard to the request for modification of performance criteria, I can see some merits to adjusting the criteria somewhat, based on changing circumstances. However, as Mr. O'Loghlin and Ms. Lissakers pointed out, considering the repeated request for a waiver and for modifications of the performance criteria, I wonder if the criteria level is too high to be met or if there is a question of ownership by the authorities. I would welcome the staff's comments on this.

I urge the new economic team to closely cooperate with the Fund and to decisively implement the program. This said, I support the proposed decision and the requests for a waiver and for modification of the performance criteria. Let me touch upon a few policy matters.

On fiscal policy, nonobservance of the performance criteria proved that, at the previous Board meeting, the authorities were too optimistic about achieving the fiscal targets. I expect the authorities to immediately implement all the measures in the program.

Concerning provincial finance, measures to improve independence of the provinces are needed. I would recommend that some benchmarks for provincial finance be established to facilitate close monitoring.

On monetary policy, it is encouraging that market confidence has improved due to the recovery of the banking sector. The central bank's free reserves should be strengthened, to develop a cushion against external shocks. I welcome the establishment of a credit line between the central bank and foreign banks, but the authorities should be cautious about the potential moral hazard of this scheme.

It is worrisome that unemployment remains high. While the medium-term scenario predicts further economic recovery, I wonder if unemployment is expected to decrease as the economy picks up. I would welcome the staff's comment.

On external policy, the level of the external debt and its burden to the federal government remain high. While market confidence is improving, the authorities should consider the impact that placing bonds will have on the future fiscal position.

With these remarks, I wish the authorities further success.

Mr. Autheman made the following statement:

The package of corrective actions announced by the authorities in August to resolve some of the structural impediments of the Argentine economy have not yet fully alleviated the concerns which arose following the significant slippages in the implementation of the program and the uncertainties created by the change in the economic management team. We agree with Mr. Zoccali that no major change in policy direction took place in Argentina, and the slippages cannot be considered as backtracking. However, it is very disappointing to see that the adjustment process undertaken in 1995 has been interrupted in 1996. The staff qualifies the fiscal impulse as neutral in 1996. I agree that neutral is better than positive, but we had expected, when we approved this program, a negative impulse and a continued adjustment process.

It is difficult to know whether the package of measures will be more effective than the previous ones, since I am not yet fully confident that they address the fundamental weaknesses in tax collection in Argentina. There appears to be too much reliance on ad hoc measures aimed at addressing emergency needs and not enough on a significant improvement of the tax system. For instance, it is of concern to see that a country which has had a long relationship with the Fund is still unable to design a satisfactory income tax system, with income tax revenue amounting only to 2.3 percent of GDP, and dividends and interest remaining untaxed. Therefore, if we fully support the intentions of the Argentine government to redress the present situation, we share the sense of uncertainty expressed by some colleagues, although I would not go as far as Mr. O'Loghlin in challenging our own integrity.

I would like to stress that the need for fiscal balance in Argentina goes further than the mechanics of a currency board. In my view, it is related to two fundamental features of the Argentine economy, which would remain, whatever happens to the currency board. The first one is the high level of public indebtedness. When one only looks at the ratio of debt to GDP, the figure appears reasonable; but one must take into account the weakness of the external sector in Argentina and the very high share of debt service to exports, since more than one third of export revenues is swallowed by debt service. In this regard, the prospect of a rising debt service between 1997 and 2000 shows the need to reach rapidly fiscal balance in Argentina.

The second factor is the extent of the dollarization of the economy, which means that the option of devaluating the currency is not a credible one, because its most probable impact would be to accelerate an already very high dollarization. In this regard, I tend to think that in Argentina, as in other countries in the region, not enough analytical work has been done to understand the present trends which underlie this dollarization behavior. As rightly pointed out by a recent working paper by Mr. Savastano, "it is almost a decade since Bolivia's successful stabilization and half that time since Peru and Argentina abated inflation and embarked on the arduous task of regaining macroeconomic stability." Therefore, we can no longer associate dollarization to the lack of stabilization, and I would warmly endorse the conclusion of this paper, which stated that "further research aimed at improving our understanding of the dynamics of dollarization in the aftermath of stabilization seems well overdue." I expressed this view when we discussed Peru, and I would like to express it again today. Our recurrent discussion about the viability of a currency board would gain a lot if we addressed this issue.

I support the request for waivers on the grounds that, in spite of slippages, the Argentine government has maintained its policy course, and with the expectation that corrective measures will be fully implemented.

Mr. O'Loghlin clarified that his reference to the "integrity of the conditionality of Fund programs" reflected his chair's concern about the perceptions that policymakers in program countries might have of the Board's seriousness regarding the need to observe program targets or structural benchmarks, not the Board's perceptions of those targets.

Mr. Jonáš made the following statement:

I am encouraged that both Argentina's economic program and its currency board arrangement have survived the recent shocks. Argentina's financial situation seems now to be stabilized and market confidence restored. But I share other Directors' disappointment with the slippages that have occurred under the program. In particular, the weakening of the public finances is cause for serious concern and should be quickly reversed. And the most recent data in Mr. Zoccali's statement indicate that the recovery is now gaining strength, the economy remains vulnerable to political pressures and changes in confidence.

The most serious slippages having occurred in the fiscal area, it is appropriate that the authorities are focusing on fiscal policy, although the size of these slippages makes me doubt that their efforts are sufficiently ambitious. Let me explain why.

During the first half of 1996 actual federal government revenues fell 0.7 percent of GDP short of the original target, and the revised program now assumes that for the whole of 1996, the revenue shortfall will reach 1.3 percent of GDP. A shortfall of this size is somewhat disturbing. I would have expected the authorities to try, during the second half of 1996, to overcome the revenue shortfall and excess deficit incurred during the first half of the year, but the staff informs us that they have decided not to try to meet the original fiscal targets for fear of interrupting the recovery.

The authorities' efforts on the expenditure side seem more appropriate, but I see problems there as well. Their decision to introduce monthly budget authorizations to get closer control over spending by the ministries is welcome, because excessive spending on goods and services was the main source of the noninterest spending overruns during the first half of 1996. But I have to ask how the authorities can justify a 12 percent increase of wage expenditures from the first half to the second half of 1996. The 12 percent increase is not as bad as the 16 percent increase originally planned, but given

Argentina's worsening fiscal picture, even greater restraint in wage spending would have been appropriate.

The severe revenue shortfall has combined with insufficient spending restraint to produce a much higher fiscal deficit. The staff's figures indicate that if discretionary spending follows the original 1996 program and revenues continue their current trend for the remainder of the year, the 1996 federal deficit will reach 2.2 percent of GDP. The revenue package introduced In September should reduce this deficit to 2.1 percent of GDP. I cannot regard this as a very ambitious remedy, even if allowance is made for the time required for revenue enhancing measures to work and the short time left till the end of the year. Argentina's indicator of value-added tax efficiency is very low compared with its neighbors, which suggests that there are large deficiencies in the tax system and large room for improving revenue collection.

Concerning the banking sector, it is encouraging to see that public is regaining its confidence in the banks. But more needs to be done. The staff is correct to insist on the importance of privatizing the state-owned Banco de la Nación. The authorities are more cautious, arguing that this bank plays an important role in financing small businesses and cooperatives. However, in my view, the existence of a state-owned bank is not the only way of ensuring that there will be adequate credit for small enterprises. A more promising approach would be to make it more attractive for private banks to extend credit to this group of clients. An important step in this direction is the establishment of a central register of small borrowers which by providing information about their credit history will make lending to them less risky and more attractive. As to the privatization of provincial banks, let me ask the staff to clarify the situation. During our March 1996 discussion, the staff informed us that ten provincial banks were in the process of being privatized. Now the background report informs us that 14 provincial banks had been privatized by August, and that the privatization of three more has been authorized; but that there are no plans to privatize the other 10 provincial and municipal banks. How is this situation related to the March plan to privatize ten banks?

Structural problem number one is the high unemployment. When output was growing rapidly, employment growth lagged behind. When output declined in 1995, employment declined just as fast, but when output recovered in 1996, employment did not follow. This pattern is indeed disturbing. The staff feels that the slow growth of employment is at least partly due to the improvement in total factor productivity associated with restructuring. I would stress that restructuring is only part of the story. It might contribute to faster labor shedding, but for me the most serious problem is with labor hiring. Labor laws and high labor costs are still important disincentives to hiring in Argentina. Mr. Zoccali suggests that one factor contributing to high unemployment may be stronger competition stemming from trade opening. I agree that trade opening can lead to higher unemployment, but only in a distorted environment where the markets are not allowed to adjust.

In conclusion, let me say that it is unusual to grant a waiver to a country that has missed all six of its performance criteria. However, I agree with the staff that despite obvious risks, the revised program should be capable of preserving Argentina's financial stability, and I support the proposed decision. Needless to add that the room for further slippages is close to zero.

Mr. Levy made the following statement:

When reading the staff report, I was first of all impressed by the significant improvement in the solidity of the banking sector and the strengthening of financial market confidence. As real economic activity has yet to follow suit, the challenge for the Argentinean authorities is to maintain public support for the reform effort so that the remaining measures can be taken. These measures will need to be targeted at the labor market and revenue collection.

Before going into the policy issues let me note that we can go along with the requested waiver, although the size of the revision is certainly substantial. I trust that the revised targets not only account for this year's slippages, but also prevent further slippages by inserting a new realism into the program. A repetition of slippages followed by strong and painful corrective measures could further exacerbate the adjustment fatigue among the Argentine public, and would also affect the credibility of the Fund program.

Regarding the policy issues, I would first like to comment on revenue performance. The failure to attain revenue targets was the main cause for previous slippages, and is at the heart of the recent slippages as well. But while previous falls in revenues could largely be traced to disappointing growth, this time the main causes are linked to policy performance such as the failure to eliminate exemptions, unplanned excise tax cuts, and weak value-added tax and social security administration. At the same time, the authorities are also to be commended for the strong corrective measures which they took once the slippages became apparent. Regarding future measures, I would like to note that we should urge the authorities to eliminate exemptions and loopholes, but not to further increase tariffs and tax rates. The actual rates are not the problem, and raising them could in fact have a negative effect on resource allocation. Revenue performance would also benefit from restructuring the relationship between the federal and provincial governments. At the moment, two thirds of the sizable transfers to the provincial governments are automatic and nonearmarked. We agree with the staff that the development of provincial revenue sources would provide better incentives to control spending at the provincial level while increasing the incentive at the federal level to improve the collection of co-participation taxes.

On labor market reform, it is truly worrisome to see that unemployment has remained stubborn this year. Employment as such actually shrank this year. Clearly then, it is of paramount importance to strengthen the link between GDP growth and the growth of employment. Tackling the rigidities in the labor market is at the core of this effort. Liberalization of the labor market is all the more important in the current environment of price stability, where downward rigidities can significantly inhibit the adjustment of relative wages and prices.

On external policies, last year this chair expressed concern about possible trade diversion as a result of Mercosur. At that time, staff did not see any clear indications of such effects. However, reports about the protection of inefficient industries by Mercosur tariffs have recently surfaced in the press. In this light, the increase in Argentinean tariffs on capital goods imports is an unwelcome side effect of the trade agreement, especially as a recent unpublished World Bank study shows that trade diversion in Mercosur is most clearly visible for capital goods, and Mr. Zocalli's statement notes that there was a surge in capital goods orders this year. I would appreciate the staff's comments on the extent of trade diversion under Mercosur.

As I noted at the beginning, the most welcome news in the staff report regards the banking sector and financial market confidence. Last year, we had serious concerns about the solidity of Argentina's banks, up to the point where some called the appropriateness of the exchange regime into question. It seems fair to conclude now that the banking system has weathered the storm. At the moment, it appears that the economy is at a point where confidence has resumed enough for peso deposits to return to the banks, but not enough yet for a resumption of private sector lending. If economic stability is maintained, this should be a transient phase. The establishment of a credit bureau by the BCRA should help to speed up the resumption of private sector activity.

On the policy of the BCRA, it is interesting to see how the bank is coping with the constraints of a currency board. Although it only has limited possibilities to act as a lender of last resort, it has established a line of credit with foreign commercial banks for that purpose. And although the central bank can not remunerate reserve requirements, it has established a contract with foreign commercial banks which allows Argentinean banks to deposit their reserves there. One could say that as a result of the currency board constraints, the BCRA is outsourcing central bank functions to the private financial sector. This has allowed the BCRA to refine its monetary management without violating the exchange rate regime. I found this an interesting development that sheds some new light on the workings of a currency board. As Mr. Autheman suggested in his statement, These experiences could be included in a possible future staff study on the operations of currency boards.

Let me end by reiterating our support for the authorities' efforts. On balance, they are continuing to show strong resolve in a truly difficult environment. It is also encouraging to note the authorities' interest in a follow-up arrangement in order to consolidate structural reforms. This program should also help to sustain financial market confidence. In due course, we should discuss the appropriate character of the next program, in light of the prospective balance of payments need and the level of access to the international capital markets.

Mr. Martinez Oliva made the following statement:

First of all, let me thank Mr. Zoccali for the updates to his statement, which brings us useful additional information. I am glad to see that the recovery of the economic activity in Argentina is consolidating, after the dramatic decline of last year. The resumption of the growth process brings about signs of renewed confidence by the market, which is positive. The fiscal performance in recent months and the missing of all performance criteria for end-June 1996 risk to work in the opposite direction. Like Mr. O'Loghlin and other speakers, I find that the repeated difficulties shown by Argentina in meeting the performance criteria over past years is a source of concern.

According to staff calculations, cyclical effects seem to have little or no influence on the fiscal slippage, depending on the assumptions that are made on the potential rate of growth. On the contrary, difficulties seem to have emerged in the implementation of fiscal policy, leading to a revenue shortfall which accounts for almost 80 percent of the deterioration of the fiscal position in 1996. The recorded shortfall in revenue—largely attributable to lower-than- expected value-added tax collection and social security contributions— indicates that difficulties in tax administration might prove hard to defeat.

Even if at this stage there is apparently no room for meeting the program's targets on the deficit of the federal public finances for the rest of 1996, the need to limit the fiscal imbalance to the minimum possible extent clearly remains. Keeping the federal government deficit at least within 2 percent of GDP for this year, and 1 percent for the next, may be crucial to underpin confidence, and to avoid unwanted negative market reactions.

While tight control over spending in 1996, and the Congressional approval of legislation limiting discretionary spending next year, is certainly relevant to this aim, a stricter control over revenues, as announced by the authorities, seems particularly appropriate, as revenues have already proven to be the main source of slippage. Implementing all the reforms necessary to create the appropriate setting for an efficient management of public finance in the future is also highly recommendable. Reinforcing the fiscal structure with measures aimed at improving the tax system and its administration is needed to achieve a better control of the budget. To this objective the steps being taken to raise efficiency and improve the ability of the tax administration agency to audit and collect tax debt are important, together with measures aimed at enhancing value-added tax collection.

On structural reform, the Policy Memorandum includes a large number of areas, ranging from social security, provincial finances, and the financial system to the reform of the State, the labor market and privatization. All the measures and interventions listed in the document appear consistently oriented toward increasing the efficiency and the flexibility of the economic system, both public and private. We cannot but encourage the government to proceed firmly along this ambitious route. I am also glad to see that the Memorandum does not overlook the aim of equity and social protection, particularly concerning the unemployed, whose share on the labor force is excessively high. This is a problem that we know and which needs strong action.

In conclusion, the economic perspectives of Argentina seem strongly related to the authorities' success in the implementation of macroeconomic policy and structural reform in the months ahead. As I am persuaded that the authorities are well aware of the increasing risks involved in deviations from adjustment and reform. In the light of the resolve shown so far and of their commitment to adopt additional corrective measures, if needed, I can agree to support Argentina's request for waiver and modification of performance criteria.

Mrs. Coronel made the following statement:

Progress in Argentina since the adoption of the Convertibility Law five years ago has been substantial. Inflation, which had reached unprecedentedly high levels, is now absent; export growth has been robust and broad-based; the public finances have reflected continuous fiscal discipline; most public enterprises have been privatized; and GDP had been growing steadily at high rates until the recession of 1995, which was induced by exogenous factors. The authorities should be commended for this approach to macroeconomic management, a costly but fruitful one.

This being said, Argentina faces a considerable challenge, namely the achievement of sustainable growth that would help reduce the high level of unemployment. When pursuing growth, the authorities have also the difficult mission to avoid that their daily economic management produce changes in market sentiment that could risk the hard-won price stability. The way to accomplish both objectives—sustainable growth and private sector confidence—is well known, though not simple: to persevere in fiscal adjustment.

In this context, the recent weakening of the federal government finances does not work in the correct direction. While the fiscal deviation is partially explained by lower than envisaged levels of consumption, most of it is the result of slippages in tax administration, a shortfall in revenue from social security contributions, unplanned cuts in excise taxes, and an overrun in expenditure in the area of goods and services. We welcome, therefore, the front loaded adjustment contained in the package of measures that went into effect at the end of September, which should help the authorities meet their new fiscal objectives for the end of the year.

At the same time, we encourage the authorities to take additional remedial actions on the lines suggested by the staff. With an already high value-added tax rate, efforts should be directed to broaden the tax base and combat evasion, through institutional changes. But, equally important, a strict control over spending should be introduced in the months to come, both in the federal government and in the provinces. It is vital that in the future the provinces maintain the discipline they are showing during the current year.

The higher than expected cumulative net increase in public sector debt during the first half of the current year reflects the availability of resources to finance the deficit. However, an active reliance on borrowing could motivate tensions in the market, especially in Argentina where fiscal relaxation can be viewed as a threat to the stability of the Convertibility Plan.

The staff's information that the authorities intend to reverse the slippages that occurred in the first half of 1996 with respect to the performance criteria in the international reserves and net domestic assets so as to meet the original targets for end-1996 is encouraging. This means that credit to the private sector will expand at a moderate pace—about 6 percent—which seems to be a cautious speed in the present circumstances. The mechanism, described in Mr. Zoccali's statement, that will allow commercial banks to count with a privately funded lender of last resort scheme is an innovative strategy that could be helpful in strengthening the confidence in the banking system and the sustainability of the convertibility arrangement.

On structural reforms, we look forward to the expected new legislation on the pension system, and on the changes to the personal income and labor taxes. The introduction of a new law to increase the flexibility of labor markets and reduce labor costs is also of upmost importance, as is the reform of the state aimed at increasing the government's efficiency in delivering services. More employment opportunities and a better quality of essential services would help build support from citizens to the program.

To conclude, we concur with the staff that a return to the original targets could involve risks to the economic recovery process. Therefore, we support the revised program. In doing so, we are certainly convinced that, in addition to firm commitments from the authorities, flexibility from the Fund is a helpful means toward the stabilization and reform objectives of developing countries.

Mr. Guzmán-Calafell made the following statement:

The Argentine economy has shown a number of positive developments during the course of 1996. The recovery of output growth from the severe decline observed in 1995 has proceeded in accordance with expectations at the time of our last Board discussion. In the case of inflation, performance has been even better than foreseen, as consumer prices are currently projected by the staff to increase by 0.6 percent during the year, vis-à-vis the 2.1 figure forecasted during our April meeting. In addition, exports have continued to show a healthy growth, the current account deficit remains within manageable levels, bank deposits have recovered, and the authorities have been able to raise a considerable amount of resources in the international financial markets.

Paradoxically, these positive results coincided with important deviations from the performance criteria contemplated under the Stand-By Arrangement, and especially with a significant increase in the fiscal deficit which contrasts with the reduction envisaged in the program. In this context, a logical question to ask is whether adhering to the initial fiscal targets was the reasonable route to follow given the evolution of output, inflation and other macroeconomic indicators. I believe that this is not the case for a number of reasons. First, as I mentioned before, the pace of price increases has been even slower than initially considered and there is no evidence of a resurgence of inflationary pressures. Second, I agree with the staff that attempting to meet the original fiscal targets risked interrupting the recovery of economic activity, a key element for the success of the economic program, particularly in light of the enormous challenges resulting from the prevalence of high unemployment rates. Third, it must be noted that in cyclically adjusted terms the fiscal impulse is likely to be about neutral in 1996. Fourth, notwithstanding the deviations from the performance criteria, confidence on the economy's outlook does not appear to have been unduly affected, as evidenced among other indicators by the growth of bank deposits, and the fact that real lending rates have fallen to their lowest level since mid-1994.

It is clear, however, that the situation continues to be fragile and that a lot still needs to be done to restore confidence in full. It may be noted, for instance, that the share of foreign currency deposits in M3 has increased significantly over the last three years, and is projected to remain during the second semester of 1996 above the levels observed in the previous year. Clearly, the dissipation of uncertainty will not be possible and the success of the program jeopardized if the markets perceive an undue deterioration of public finances. It is evident that the risks attached to a fiscal effort perceived as insufficient are enormous. This will be especially important in 1997, given the nervousness that may arise as the electoral process nears.

For this reason, the authorities' determination to strengthen the fiscal program is welcome. The decision to limit the Federal deficit to the equivalent of 1 percent of GDP in 1997 is adequately prudent, and the fact that the fiscal adjustment is front loaded provides an indication of the authorities' commitment to the strengthening of public finances. On the other hand, the Argentine authorities have succeeded in reducing the consolidated deficit of the provincial public finances. These efforts must be continued and strengthened, particularly to improve the provinces' own revenue performance, and to foster both expenditure restraint and structural reform at the provincial level.

The revised program for 1996–97 is underpinned by further efforts to strengthen the banking system and in general to accelerate the structural transformation of the economy. Since I am in broad agreement with the staff's views in these areas, I would only like to comment briefly on the unemployment situation. The persistence of extremely high unemployment rates is clearly one of the most pressing problems currently affecting the Argentine economy. It is somehow peculiar to note that this is a challenge that originates to a significant extent from the authorities' decision to implement policies aimed at enhancing the economy's efficiency and the potential for growth. As explained in the background report, the main factor behind the rapid increase in the unemployment rate in recent years is the stagnation of aggregate employment, in turn the result of the sharp improvement in total factor productivity growth that has followed the structural transformation of the economy. The pressures stemming from the increased participation rates make this problem even more complex. The efforts made by the authorities to increase the flexibility of labor markets, reduce labor costs and lower disincentives to hiring will contribute to alleviate the pressures on the unemployment rate. There is no doubt that these efforts must be continued and strengthened to the extent possible. Nevertheless, given the magnitude of this problem, a significant decline in unemployment will also require sustained rates of economic growth at or near full potential. Since this is precisely the assumption used in the medium term projections in table 7 of the report, I wonder if the staff could elaborate on the likely impact on unemployment of a pattern of economic growth as that assumed in this scenario.

The evolution of the external sector is in general satisfactory. While export growth has decelerated substantially in 1996 with respect to the figures observed during the previous year, there seems to be broad agreement that the economy's competitiveness is adequate at present. The private sector's view that competitiveness is not a source of concern at this stage is especially reassuring. On the other hand, the current account deficit is projected this year and the next at moderate levels. But I would like to hear the staff's views on two issues. First, I note that the rate of growth of the volume of imports decelerates significantly during 1997 despite the expected strengthening of economic activity, and I do not understand the reasons for this. Second, the public sector's external debt service is expected to increase substantially from around 28 percent of exports of goods and nonfactor services in 1995 to more than 40 percent in 1997. I would like the staff to comment on the potential implications of this trend.

With these comments, I wish the Argentine authorities every success in the implementation of their economic program and I support the proposed decision.

Mr. Al-Turki made the following statement:

The Argentine economy has made gains under the current Stand-By Arrangement. Reflecting also benefits of commitment to the Convertibility Plan, prices have virtually stabilized. The output recovery has meanwhile picked up as capital reflows increased. Safeguarding these hard-won gains, however, requires strong and timely action to address the slippages in implementation of the program. It is thus essential that the authorities take adequate corrective action.

I am in broad agreement with the thrust of the staff appraisal and will only make three brief comments.

The strengthening of the fiscal stance in the second half of 1996 and in 1997 is a step in the right direction. However, many of the measures that are being implemented should be considered a stop gap effort. To fully address the slippage in the revenue area, the focus has to be on broadening the tax base and enhancing collections. Ending exemptions and strengthening tax administration should be a priority. On the expenditure side, I welcome the emphasis on containing current spending. In this regard, the ongoing reform of the civil service and the social security administration is especially important. It is clearly critical that the revised fiscal targets be achieved without any further slippage. Contingency measures should therefore be kept ready for quick implementation as needed.

I welcome the progress made in addressing the weaknesses in the Banking Sector. Speed up of privatization of public sector owned banks remain essential. In this regard, the announced intention of the authorities to privatize the National Mortgage Bank is encouraging. It is also important that priority be given to enhancement of the prudential and supervisory regulations. In this connection, the improvements envisaged in the banks' liquidity position are reassuring. I welcome the steps taken to foster credit to small enterprises and in the rural areas.

Finally, despite the decline last year, unemployment remains very high. In this regard, I hope that improved economic prospects, along with the important reform of labor markets, will lead to a faster reduction in unemployment. I welcome particularly the increased flexibility envisaged in labor-management relations. Equally important is the proposed replacement of the current costly severance payments system by an efficiently funded scheme of unemployment insurance. I also endorse the staff's high priority for speed up of progress in these areas.

With these remarks, I support the proposed decision and wish the Argentine authorities success in the challenging tasks ahead.

Mr. Han made the following statement:

The Argentine authorities are to be commended for their impressive progress in macroeconomic stabilization and structural adjustment under the current Stand-By Arrangement. In my view, the authorities' determined efforts to maintain financial stability is the key to the improvement in the overall economic situation. I am delighted to see that the recent recovery has taken shape and market confidence has been markedly strengthened by the continued easing of inflationary pressures. The increase of capital inflows and the expansion of foreign trade have brought the economy on the path to further recovery. Since I broadly agree with the staff on the main thrust of the paper, I would, therefore, like to make a few comments for emphasis.

In order to safeguard the success of the program, it is important for the authorities to implement effective measures in raising revenues and tightening expenditures, so as to achieve substantial progress in fiscal consolidation. In this respect, I echo the staff warning against the growing fiscal dependence on borrowing which has increased the vulnerability of the economy to the changes in market sentiment. We welcome the recent steps taken by the authorities to increase revenue and eliminate tax exemptions and loopholes. Given the fact that the effect on the efforts to improve tax administration could only be expected in the medium term, it is crucial for the authorities to curtail government expenditures in the near future. I believe that further progress with reform of the federal administration and social security system will be conducive to the improved public services efficiency and therefore to the strengthening of overall public finances in the years to come.

A beneficial development has resulted from the orderly restructuring of the banking system, as reflected in the improved market confidence in the Argentine banking system since 1995. With the increase of banks' liquid reserves and the continued strengthening of bank supervision, the country risk and intermediation spreads of adverse financial shocks have been markedly reduced. In this respect, I am delighted to see that the central bank's free international reserves are expected to rise and the domestic assets of the banking system are programmed to be consistent with the prudent policy stance. Specifically, it is encouraging to find that a central credit reporting agency has been established. Besides the contribution to the improved bank supervision mechanism, its merits in fostering the expansion of bank credits to small enterprises and entities in rural areas have to be recognized.

The authorities are encouraged to take bolder actions in the structural reform, by enhancing the labor market flexibility, reducing the high rate of unemployment, and raising the domestic saving and investment to create a better environment for economic growth.

I believe macroeconomic stability constitutes a key element of the basic conditions for the successful implementation of a strong structural reform program. Drastic changes in financial policies should be avoided as much as possible in aiming for an orderly adjustment process under many circumstances. With this concern, I can concur with the staff reasoning for the necessary revision of the original program targets on the impacts on economic recovery and market confidence.

In conclusion, we would like to support the Argentine authorities' request for a waiver and modification of performance criteria on the fiscal consolidation under the current Stand-By Arrangement in view of its current economic conditions and I would like to wish the authorities every success in their future economic adjustment efforts.

Mr. Donecker made the following statement:

It is problematic that Argentina's adjustment program got out of hand—so shortly after its approval—mainly due to slippages in tax administration. This has damaged the credibility of the authorities—a credibility which is of particular importance, in view of Argentina's great dependence on continuing capital inflows. The revised program—which, in the fiscal area, is significantly less ambitious—will need to be implemented strictly in order to return to the adjustment path and to gain more credibility. As staff has rightly pointed out, considerable risks remain (p. 16), and there is, therefore, no room for further deviations from the program.

Since we broadly agree with staff's recommendations and support the proposed decisions, and in view of the discussion so far, I want to focus my following remarks on the most critical area, i.e., on fiscal policy.

In order to better protect public finances against unexpected nasty surprises, in our view, "contingency measures" should be worked out which could be implemented rapidly, if required. In the medium-term, a further tightening of fiscal policy would also be desirable. his would help to strengthen confidence in the authorities' program. In particular, the authorities should aim to reduce completely the fiscal deficit by the year 1998. This should be within their reach, in view of the relatively high expected growth rates in the years ahead.

To achieve this goal, it is, above all, necessary to broaden the tax base and to intensify the fight against tax evasion. There is a clear need to increase the relatively low revenues from value-added tax and income tax to a level which is comparable with that in other large emerging market economies. Furthermore, since social spending is very high, compared with other countries in the region, it should be cut back and should be more concentrated on those in need.

Some fiscal measures recently approved by the authorities, however, point public finances in the wrong direction, in particular:

First, the increases in tariffs on imports of capital goods (p. 9) and the maintenance of the "import surcharge" (p. 14), in our view, are at most acceptable as temporary measures to increase revenues. These measures, however, should be replaced as soon as possible by steps in favor of a lasting and broadly based increase in tax revenues.

Second, social benefits for the dismissed workers in the public sector appear to be very high.

Third, the decision whereby the revenue from the increase in fuel excises will not be shared with the provinces for the next two years (p. 9) is in line with staff's recommendation to slow down the growth of automatic transfers of federal tax revenue to the provinces (p. 15). But this decision should not lead to the postponement of a fair and durable agreement on the federal-provincial financial relations which is urgently needed.

Finally, with regard to the envisaged expansion of the public jobs program (p. 13), I have some doubts whether it might not lead to similar problems as experienced by other countries (for example: high fiscal costs and limited efficiency). Perhaps staff can comment on this.

Mr. Evans said that he wished to join the many Directors who had drawn attention to the missing of all performance criteria; the credibility of both the authorities and the Fund was at stake. Yet it had come as no great surprise to himself that Argentina had missed its performance targets for end-June 1996. At the Board discussion in April 1996, his chair had drawn attention to the persistently overoptimistic projections of the staff and the authorities; the fiscal shortfall in the first half of 1996 had continued that history of overoptimism.

Nonetheless, the authorities, and Minister Fernández particularly, should be commended for recent important changes, Mr. Evans noted, including their more realistic growth projections and for pushing through Congress a tough and much needed fiscal austerity package in the face of strong political opposition. The recent fiscal package would certainly help the authorities to meet their revenue targets. One had to acknowledge that, despite the recent fiscal slippages, Argentina's fiscal position was not all that bad: the projected federal deficit of 2 percent of GDP was small not only by Argentina's standards, but also by comparison with other countries in the region—not to mention some in Europe. Moreover, the background paper had indicated that there had been no deterioration in the cyclically adjusted fiscal position over 1996; but, of course, the improvement that Directors had expected had not materialized.

The fiscal projection for 1997 assumed a pickup in economic growth to 5 percent, a welcome low inflation rate of one percent, and growth in tax revenues of 13 percent, Mr. Evans observed, which suggested an unusually high elasticity of revenues to GDP growth on which he hoped that the staff would comment. The projection also required that the authorities keep a tight rein on spending in the politically difficult circumstances of an election year. He thus endorsed Directors' comments on the authorities' narrow margin for fiscal error, and echoed Mr. Shaalan's question to the staff on whether it had discussed with the authorities contingency measures in case of further fiscal slippages.

It would be difficult indeed for the authorities to make fiscal progress in the year ahead, Mr. Evans indicated. He welcomed their intention to broaden the base of income and labor taxes, but was more skeptical than the staff on the scope for achieving significant savings in the social security system; for example, the authorities' proposal to increase the retirement age for women, from 60 to 65 years, has been blocked in Congress. Moreover, caution was warranted on the savings likely to emerge from the next round of negotiations on revenue sharing with the provinces. Indeed, the whole issue of the federal-provincial fiscal relationship needed to be top priority for institutional reform in Argentina.

Argentina's recent performance had been more satisfactory on monetary and exchange rate policy than fiscal policy, Mr. Evans observed. He commended the central bank for taking a tough approach to banking supervision over the previous 18 months and joined other Directors in commending it for the new contingent credit line. As for competitiveness, he welcomed the low inflation rate and the increases in productivity. But he wondered whether the staff believed that it was a cause for concern that, over the first five months of 1996, food exports had grown by 12 percent, energy exports by 28 percent, while manufactured goods exports had shrunk by 11 percent.

He shared other Directors' concerns about high unemployment and the problems that it indicated regarding recent economic performance, Mr. Evans continued. The high unemployment rate predated the Mexican crisis, as there had been low employment growth for some years. The background paper indicated that labor market rigidities had been a major factor in the unemployment problem, and he therefore joined the staff in emphasizing the importance of the authorities' intensifying the momentum of labor market reform in order to achieve a sustainable reduction in unemployment. He wondered whether the staff or

Mr. Zoccali could comment on the prospects for congressional passage of the legislation to decentralize collective bargaining.

He agreed with Mr. Zoccali that the centerpiece of the authorities' economic policy was the currency board, which had proved its resilience, Mr. Evans said. The authorities should also be commended for their efforts to deregulate the economy. While he supported their request for waivers and modification of the performance criteria, they had not achieved nearly as much credibility as their track record merited. Indeed, Ms. Lissakers had noted that Argentina's interest rate spread over U.S. Treasury bonds had been about 400 basis points in 1996; real interest rates were still high; and international reserves were relatively low. In fact, if the program targets and performance criteria had been more realistic over the previous 18 months, Argentina would have benefited by securing more credibility from what had been, in many respects, a reasonable performance. The answer to that problem, as emphasized by Mr. O'Loghlin and other speakers, lay in the authorities fully meeting the revised performance criteria; the Board could send a strong signal to that effect. The credibility of the Fund was at stake: repeated waivers damaged Fund credibility, and he hoped therefore that the Fund might learn some lessons from Argentina's case in that regard.

The staff representative from the Western Hemisphere Department recalled that as recently as six years ago, Argentina had faced a traumatic hyperinflation, which was still fresh in the public's mind. The Convertibility Plan had restored order and normalcy to the economy, and was seen as essential to continued price stability. Given that abandonment of the Convertibility Plan would be seen as tantamount to a return to hyperinflation and chaos, the staff had not discussed an exit strategy with the authorities. Moreover, there was no evidence that competitiveness had deteriorated: the most recent real effective exchange rate data based on the consumer price index indicated that the peso had depreciated by 11 percent from January 1994 to August 1996, reflecting real depreciation against Brazil and other neighboring countries' currencies in the dollar area. Export growth had continued to be strong; moreover, as exports were only 8 percent of GDP, the disruption caused by devaluation would likely exceed any possible stimulus of devaluation to employment.

Neither was fiscal expansion seen as a solution for unemployment, the staff representative observed. Central government expenditure was only about 15 percent of GDP; the elasticity of employment to demand was low; and the adverse effects of any fiscal expansion on confidence and private sector consumption and investment might well offset any resulting stimulus to employment. In fact, there was evidence that, whenever a major fiscal restraint package had been announced over the preceding 12 months (November 1995, and March and August of 1996), bond prices had rallied and interest rates had fallen sharply. Argentine markets regarded fiscal deterioration as a cause for uncertainty, and fiscal consolidation as a cause for confidence. From the start, the program supported by the Stand-By Arrangement had been based on strengthening confidence and opening room for private sector activity, which implied the need for fiscal restraint, monetary policy that would increase confidence and thereby reduce risk premia on interest rates, and continued structural reforms to allow free working of the price system and the modernization of the economy.

With hindsight, the agreed targets at the start of the program might have been too ambitious given the economic circumstances, despite the staff's effort to be cautious regarding the availability of financing for the fiscal deficit, the staff representative commented. The deviations from the fiscal targets had been apparent to the staff during its August mission, but so had the changed economic circumstances: the increased fiscal deficit was being financed adequately in the market, confidence was returning to some extent, with a substantial reflow of deposits and an incipient increase in credit to the private sector, and economic activity was recovering. In part, those changed circumstances underlay the shift in the staff's position on the required degree of fiscal adjustment. The modified program was based on a solid package of fiscal measures that had been approved by Congress already. In addition, there were improvements in tax administration—encompassing most of the measures recommended by most recent technical assistance mission—measures to contain social security costs, and, most important, to regain the momentum of structural reform, which had stalled since mid-1994, particularly of the state, labor market, and health system.

The fiscal target for 1997 was feasible, the staff representative considered, as it was based essentially on a package of revenue measures approved and in effect already, yielding about 1 percentage point of GDP on an annual basis. The staff had not factored into the targets any increased revenues from improved tax administration or cost savings from social security measures, although fiscal gains should be expected in both of those areas, which buttressed the credibility of the announced fiscal target for 1997. In any event, the program for 1997 would be discussed in detail during the second review of the Stand-By Arrangement, when the staff visited Argentina in December 1996. The staff would also discuss, at that time, fiscal contingency measures, as recommended by Messrs. Shaalan, Donecker, and Evans.

Ms. Lissakers, noting Mr. Autheman's point that income tax revenues were low, asked whether the authorities planned to reform the structure of the tax system to raise the proportion of revenues from income compared with consumption.

The staff representative from the Western Hemisphere Department said that the intention to undertake a fundamental reform of the tax system had been included in the letter of intent, although the staff had not discussed the matter in detail with the authorities. The authorities envisaged broadening the base of the income and value-added taxes, to allow for a reduction in the high labor taxes. The staff agreed with the authorities that the reform could not be done hastily; the authorities would prepare the reform in 1997 for subsequent implementation.

Mr. Zoccali confirmed that the authorities would reform the tax system in the medium term. They would establish a task to simplify the complex tax system, to reduce the costs of compliance, and to broaden the tax base through increasing income taxes and reducing labor taxes. They believed that it would be disruptive to reform the tax system at present—to change the rules of the game, as it were—at a time when they were seeking to consolidate tax administration. In fact, such an effort would, at present, offset the gains of their strategy to counter tax evasion. The authorities fully shared Directors' concerns regarding tax administration, and their view of the further scope for improvements. They were confident that concrete improvements in tax administration could be achieved, and were grateful for management's authorization for an Argentine national in the Fiscal Affairs Department to return to Argentina to head the internal revenue and the customs administration. In any event, it was an important departure from previous programs that no improvements in tax administration had been incorporated into the program's revenue projections.

Ms. Lissakers commented that, while she understood the authorities' reluctance to change the tax regime constantly—which could be disruptive and in the short run, costly in terms of revenue—there was a real cost to delaying the shift of the high tax burden on labor to income, to help reduce the high unemployment rate. There was tentative evidence of taxpayers' growing resistance to paying consumption-based taxes. Part of the decline in the ratio of tax revenue as a share of GDP since 1994 resulted from changes in the social security regime, but part also resulted from an erosion in the ability of the government to collect taxes.

Mr. Sivaraman added that he agreed with Ms. Lissakers. Given the real difficulty with tax compliance in Argentina, it was problematic that many of the authorities' recent revenue measures consisted of increased tax rates and tariffs, and reduction of tax rebates. As even the previous tax amnesty had not yielded good results, he wondered whether increased tax rates would exacerbate the compliance problem. His personal experience with tax reforms was that it was counterproductive to increase tax rates when there was a compliance problem; revenues would, in fact, drop.

The staff representative from the Western Hemisphere Department said that the projected 13 percent increase in tax revenues in 1997 did not result from high elasticity of revenues to GDP, but from the new revenue package, which would increase revenues by about 1 percentage point of GDP. Mr. Sivaraman's general point was correct, but in Argentina's case, most of the tax rate increases in the revenue package were on fuel, which was an easier tax to collect than others. The other tax rate increases were mainly minor ones; most of the revenue package consisted of measures to close loopholes and to increase coverage, not to increase rates. In framing their measures, the authorities were conscious of the problems of tax evasion and exhaustion.

There were several reasons for the decline in the tax revenue share in GDP, including, the staff representative noted: growing public resistance to paying taxes, the lack of a proper legal penalty for tax evaders, the fact that tax amnesties had created a culture of impunity for tax evaders, and the major effect of the recession and lack of credit available in 1995. With liquidity problems and a slowdown in business, many people had opted not to pay taxes—a problem that should be corrected by the economic recovery and increased credit. The federal-provincial fiscal relationship, which was another aspect of the revenue problem, was currently under discussion in Argentina. The problems with tax administration should not be exaggerated, moreover, as significant improvements had been made in that area in 1991–93, and the tax agency had embarked on a major corrective program. The authorities were also taking several administrative measures to increase the number of participants in the social security system, by extending it, inter alia, to the self-employed and rural workers. They had requested technical assistance from the Fiscal Affairs Department to help with the collection of contributions.

Much of Argentina's unemployment was structural, and would take time to reduce, the staff representative stated. Simple calculations indicated that, even if Argentina were to close its output gap, it would still have an estimated unemployment rate of 13–15 percent, given the relatively low elasticity of employment to output growth. The decline in real wages since 1994 was a slow process; yet with inflation nearing zero percent, nominal wages were starting to fall as well. The authorities were focusing on reducing labor costs and increasing labor market flexibility. They had reduced social security contributions in 1996 and would do so again as soon as it was feasible in fiscal terms, particularly if fiscal revenues exceeded program projections. Legislation on labor market reform had been tabled in Congress, including on free bargaining, working conditions including work times and leave decisions, and employees' indemnification in case of dismissal. While it was too early to predict which measures Congress would approve, President Menem was determined to implement the reforms, and had said on record that he would implement them by decree if Congress had not approved the legislation by March 1997.

Mr. Daïri commented that he doubted that structural unemployment could rise by almost 10–12 percentage over just four to five. The increase in the participation rate, which the staff had mentioned as a major reason for the increase in unemployment, might have been derived as well from the increase in labor costs in the few years following implementation of the Convertibility Plan; Table 15 of the background paper on selected issues indicated that, in fact, the weighted average of relative labor unit costs had increased 27 percent over 1991–94, and had decreased by 21 percent since March 1994. While labor costs were currently falling, the authorities must have followed an inappropriate policy mix until 1994. Perhaps an extrapolation of those trends would indicate that unemployment would continue to fall irrespective of structural changes and labor market reforms—although the reforms to wage bargaining should help to reduce the unemployment rate. In short, the rise in unemployment could not be related solely to rigidities in the labor market, but had to be related as well to, perhaps, excess wage settlements.

The staff representative from the Western Hemisphere Department clarified that he had used the term "structural" in the sense of noncyclical, and had not meant to imply that labor market rigidities were the only cause of unemployment. Before the recession, unemployment had increased from 5 percent to 12 percent, and since the recession, it had increased further to 17 percent—although it was declining slowly at present. Wage policy and technological modernization might have contributed to the increase in noncyclical unemployment. The authorities were seeking to target the social safety net by designing more specific programs. Thus far, the unemployed seemed to have relied on general assistance programs, including health benefits, and on extended families (the unemployment rate for the heads of families was only 6–7 percent). The authorities were also seeking financing from multilateral aid agencies for a special assistance program aimed at the heads of households and teenagers. Wage payments in the federal government appeared to have been higher in the second half of 1996 than in the first half, because June wages had been paid in July, and December wages included the traditional Christmas bonus.

Mr. Evans asked what had caused the big increase in structural unemployment. Perhaps in the past, structural unemployment had in fact exceeded actual unemployment.

The staff representative from the Western Hemisphere Department responded that the increase in total factor productivity explained much of the drop in the demand for labor, as did the low elasticity of employment to growth. Moreover, privatization had resulted in much labor shedding, as had the modernization of the industrial stock, including the importing of new technologies. The Convertibility Plan had brought out into the open the hidden unemployment in the private and public sectors of the 1980s, when output had stagnated, investment had atrophied, and the capital stock had depreciated. It was hard to say whether the rise in unemployment stemmed mainly from the stagnation of the 1980s or developments in the 1990s.

Mr. Daïri reiterated that the rise in wages was probably the cause of the increased participation rate, and thus of increased unemployment; in fact up to 80 percent of the recent decline in the unemployment rate was attributable to a fall in the participation rate, not to job creation.

The staff representative from the Western Hemisphere Department stated that the staff's projected increase in growth to 5 percent in 1997 was based on a recovery in investment which was ongoing at present and private consumption. There were indications that, as credit levels normalized, households adjusted their debt stocks, and employment rose—even slowly—confidence and private consumption would recover. The external sector was projected to have only a neutral impact on growth in 1997. Current data indicated that growth in 1996 might exceed the projected rate of 2½ percent, and reach 3 percent, implying that growth in the third and fourth quarters of the year was exceeding 6 percent compared with that in the same quarters of 1995. The staff's projected resumption of growth followed typical recoveries in Argentina from recessions, and was thus not overly optimistic.

The recently published paper from the World Bank on MERCOSUR was not an official Bank paper, and the Bank recognized MERCOSUR's positive aspects, the staff representative pointed out. Argentina's external tariff had declined since joining MERCOSUR, and currently averaged 9–10 percent. Argentina's trade had more than doubled in the previous 4 years; trade within MERCOSUR had increased by 33 percent a year and outside MERCOSUR by 17 percent a year. Imports from the European Union had increased by 40 percent a year, exceeding imports from MERCOSUR which had increased by 38.8 percent. The Bank's paper might have been overly influenced by developments in the automotive sector, where external tariffs remained high. Even in that sector, there had been much specialization within MERCOSUR, with companies choosing to produce one brand in one plant in one country, and another brand in another country, which had helped to increase the efficiency of Argentina's automotive production. What would have happened to trade flows in the absence of MERCOSUR was open to question, but the direct evidence of trade diversion was hard to pinpoint thus far.

Mr. Zoccali added that trade between Argentina and Chile, which was not a MERCOSUR country, had increased more than trade between Argentina and MERCOSUR. Perhaps unilateral trade opening had been the cause of that growth in trade. The World Bank paper on MERCOSUR was based on a limited series of statistics, not going beyond 1994. That was problematic, given that countries had implemented significant structural reforms since then. Argentina and the other members of MERCOSUR were prepared to discuss the MERCOSUR agreement with the World Trade Organization.

The staff representative from the Western Hemisphere Department remarked that the external public sector debt, at 24 percent of GDP, was not high; but as a percentage of exports it was high, at over 200 percent, reflecting how closed the Argentine economy had been until a few years before. Exports were growing rapidly, but still had a long way to go. About 22 percent of Argentina's debt was debt to multilateral agencies, 32 percent to commercial banks, and 36 percent consisted of bonds—most of which were at a fixed rate.

While interest rate spreads were a complicated matter, depending on what variables one measured and when spreads were tending to fall and maturities to increase, the staff representative pointed out. Yields had fallen sharply since 1994, but interest rate spreads, at 445 basis points on a 10-year dollar loan, remained slightly higher than in 1994—although far below their 1995 peak. The maturity of Argentina's debt had increased greatly, from an average maturity of 3½ years in 1994 to 7¾ years so far in 1996; a good example was the 30-year loan in deutsche marks in that current week.

The staff had projected that import volume would drop in 1997 because the bigger increase in import volume in 1996 reflected catch-up and import restocking following the collapse of imports in 1995, the staff representative commented. After 1997, growth in import volume would resume at a more normal, but still rapid, rate. Similar reasoning applied to the projected increase in interest payments over the next few years, which reflected the bunching of maturities in 1996/97, and which would decline thereafter.

The drop in industrial exports in early 1996 reflected the fact that such exports had been extremely strong in the first quarter of 1995, the staff representative noted. The problem would disappear as the year progressed.

Mr. Kang made the following statement:

> At the outset, we commend the Argentine authorities for the significant recovery that has been achieved in the aftermath of the Mexican crisis. The dramatic and sustained reduction in the inflation rate is admirable and the resumption of growth encouraging. The comprehensive structural reforms that have been put in place over the last five and a half years have certainly helped weather the crisis of confidence that afflicted Argentina along with other emerging markets early last year. We could support the proposed decision but wish to comment about the Argentine program in general, and raise some points of detail.
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> We regret that all performance criteria were missed shortly after the standby arrangement was approved. From the point of view of an outsider looking in, this casts doubt about the commitment of the authorities to the objectives of the program. Alternatively, this could suggest that the program design was flawed from the start in that targets were unrealistic. I would like to build my general comments about the program on these possibilities.
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> When the request for the standby arrangement was considered by the Board in April, a number of Directors praised the authorities for front-loading the adjustments in the Argentine program. Fiscal consolidation was appropriately recognized as the central objective, along with the pursuit of structural reforms. Six months after the request was approved we are now looking at a situation where performance in many areas was way below expectation. Yet staff appears only too ready to propose approval of the authorities' requests for the completion of the review, the grant of waivers, and the modification of certain performance criteria. It would be useful if staff could provide a strong justification for this. It seems to me that the endorsement of the requests suggests that either staff recognized that there was a mistake in the design of the program, i.e., the performance targets were overly ambitious and hence, unrealistic; or that changed conditions have made the program assumptions unrealistic. While both could be relevant in this case, there are also indications that actions fell short in some areas.
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> Given that all six performance criteria for end-September were missed by wide margins, I wonder what the chances are for meeting the targets for end-1996. Authorities requested for a revision of the targets on the fiscal deficit and public debt only which seems to suggest that they are confident

that the other four performance targets could be met. I wonder if the catching up time is long enough to bring the program back on track by the end of the year. The staff or Mr. Zoccali may wish to remark on this point.

In cases where programs are subsequently determined to be over-ambitious, I wonder if staff may not take some part of the responsibility for the deviations of actual performance from the program. Perhaps management may consider devising some procedure to evaluate the staff's work on the basis of program performance in order to ensure more pragmatic and realistic program design.

We regret that the slippages in the fiscal sector were due to continued weaknesses in tax administration and to some spending overruns in discretionary items. While some recovery in confidence is evident from the slight acceleration in the growth of bank credit and the reflow of capital, a firmer commitment to fiscal consolidation demonstrated in concrete efforts to strengthen revenue (e.g., through the removal of value-added tax exemptions, and expansion of the income tax base along the lines suggested by the staff); and to improve the management of expenditure would be crucial if market confidence and the economic recovery are to be enhanced and sustained. In this regard, we welcome most of the recent measures announced by the authorities. It might also be useful to review revenue sharing arrangements between the National government and the provinces while exploring the possibility of devolving some functions to the latter as may be practicable.

Looking at data presented in tables 27 and 36 of the background paper, real interest rates on deposits and loans to prime borrowers have remained high. I note the explanation given by Mr. Zoccali in his statement but I think that the persistence of high interest rates (and wide real interest rate differentials vis-à-vis industrial countries) could also suggest that markets still perceive some uncertainty about the prospects of the Argentine economy. This could also be indicated by the fact that capital flows (other than to the National government) have remained small. Indeed, in the first half of 1996, net capital outflows were recorded for the financial system while capital flows to the nonfinancial public sector declined from the same first half period in 1995. The staff's analysis of this development would be useful.

On matters of detail, we would like to raise nine points on which the staff comments would be appreciated:

a. Was the staff consulted in the grant of a tax amnesty in late 1995? Is the staff aware of a case where tax amnesty was successful?

b. Is the low value-added tax efficiency (0.29) a consequence of the too high rate (21 percent)? I believe that a high value-added tax rate naturally leads to lower compliance, including formal requests for exemptions. It would be helpful if we could have information on the value-added tax rate, on average, of countries that have more successfully implemented the value-added tax.

c. The inflation rate has dramatically dropped and expected to average under 1 percent for the whole of 1996. In this situation, what is the expected benefit from continuing with the convertibility plan?

d. The recent revenue measures included an increase in the tariffs on capital goods imports which is opposite to the normal practice in other countries for increasing investments. Is the increase not expected to discourage investments and reduce external competitiveness?

e. To improve tax administration, authorities plan to impose fines on consumers who fail to request sales receipts. In my view, it would be more desirable and probably more effective to provide a tax credit for those who get sales receipts.

f. The staff noted that the Argentine economy has maintained competitiveness even after the introduction of the convertibility plan, owing largely to favorable developments in the Brazilian economy, the depreciation of the US dollar, and productivity growth. I wonder whether this would remain valid in coming years. I would suspect that the recent strengthening of the US dollar and the maintenance of the exchange rate peg would likely impact negatively on Argentina's trade account.

g. Is the credit rating agency publicly-owned or privately-owned? Such an agency could benefit from competition.

h. The recent increase in the already high reserve requirement on bank deposit liabilities and the setting up of the deposit insurance scheme fully funded by banks should help enhance confidence in the banking system. At the same time, however, these would increase the cost of financial intermediation further and weaken banks' competitive position vis-à-vis nonbank financial institutions, and foreign banks.

i. Mr. Zoccali said in his statement that more than a third of the unemployment at end-1995 could be attributed to the increase in the participation rate since 1991. I wonder how the labor participation rate could increase in a situation of high unemployment. I am inclined to agree with staff that the more important factor has been the slower pace of job creation relative to real GDP growth owing to high employers social security contributions and insufficient labor reform. In 1993, the labor force was reported to have increased by 4.5 percent from the previous year, which is unusual. We need more analysis on that.

In conclusion, we believe that Argentina's recent economic performance vis-à-vis its program illustrates the need for both an improvement in the design of economic programs in general (i.e., to make programs ambitious but realistic) and for stronger policy actions by the authorities to achieve their program objectives. Changes in performance targets, especially at the early stage of the program implementation, should be avoided to safeguard the credibility not only of the program but also of the Fund which is supporting it. This being said, like Mr. O'Loghlin, we are willing to give the

Argentine authorities the benefit of the doubt while urging them to remain steadfast in the pursuit of the required adjustments and reforms.

We could support the proposed decision and wish the authorities the best in the period ahead.

After adjourning at 12:50 p.m., the meeting reconvened at 2:35 p.m.

Mr. Kpetigo made the following statement:

I would like to join previous speakers in commending the Argentine authorities for their continuing commitment to the reform process. As a result, considerable progress has been made in the stabilization and the deregulation of the economy. Overall, confidence in the authorities' policies has strengthened, as evidenced by increased access to international capital market and increased bank deposits. With the recovery under way, the authorities should seize this opportunity to make further progress toward fiscal consolidation and accelerate structural reforms where progress has been lagging behind the program's objectives.

On the fiscal front, available data and projections suggest that, in the short term, the federal deficit could increase somewhat, causing the government to resort to commercial borrowing. Therefore, I welcome the authorities' readiness to take additional measures to meet the revised fiscal targets.

On the revenue side, like previous speakers, I agree that the authorities should take bold actions to broaden the tax base, strengthen customs and tax administration, so as to intensify revenue mobilization efforts. The steps being taken by the authorities, notably to reduce tax exemptions on the value-added tax, and reinforce tax compliance go in the right direction. The measures adopted by the parliament or contemplated by the authorities should be introduced in a timely way, bearing in mind that some measures, including the audit of the social security administration and a new system of monthly budget authorization might take time to produce their expected effects.

On the expenditure side, overruns are a cause for concern. Thus, I welcome the authorities' efforts to tighten expenditure control for the remainder of 1996 and in 1997. I would, however, urge them to undertake a comprehensive restructuring of public expenditure, in order to improve resource allocation, so as to increase public investment, which is critical for sustainable growth over the medium term.

In the banking sector, the pursuit of strong measures are critical to a continued recovery of the public's confidence in the financial system.

On structural reforms, bold steps have been taken but much remains to be done, mainly to address the social security issue, accelerate the privatization process, and reform the labor market. The authorities have already identified a package of measures that, if forcefully implemented, should bring about substantial benefits to the economy, including increased competitiveness through cost reduction and better delivery of services.

On the debt situation, Argentina's debt remains heavy and the authorities should therefore, pursue prudent debt management policies, in order to improve the debt profile. I agree with the staff that it is essential to tighten legislation regarding the contracting of debt by local governments.

With these remarks, I support the authorities' request for waivers and the modification for performance criteria, and wish them every success in their reform process.

Mr. Lvin remarked that the design of the value-added tax seemed to be faulty, if it were necessary for the authorities to penalize customers who had failed to request receipts. The conventional view of the advantage of the value-added tax was precisely that retailers had strong incentives to issue receipts for the largest amounts possible to offset their own payments under that tax. His point was supported by the staff's analysis of the low efficiency of Argentina's value-added tax; and he hoped that the staff or Mr. Zoccali would comment on the design of the value-added tax, and means of addressing its weaknesses.

Issues of federal federalism were known to be among the most difficult to address in Argentina, Mr. Lvin recalled. Thus he strongly commended the progress that had been achieved so far in stabilizing the provincial finances and in launching provincial privatization programs. While the authorities' intention to shift some expenditures from the federal to the provincial level should be implemented vigorously, he wondered why they had decided on the modest accompanying goal of only slowing the growth of federal tax transfers to the provinces. He wondered whether it would make more sense to shift some revenues to the provinces instead of sustaining a complex and highly politicized system of revenue sharing and transfers and how the introduction of provincial sales taxation, presumably along U.S. lines, would influence the value-added tax, which already had high rates?

He strongly welcomed the authorities' intention to reinforce their privatization program, Mr. Lvin stated. However, the authorities should not rely on privatization as a source of revenue, given that their privatization program targeted mainly large-scale enterprises, where legal and other issues might cause delays.

Following the bold implementation of pension and health service reforms, the education system seemed to be the logical area to reform next, Mr. Lvin considered. The ineffectiveness of the current education system seemed to be reflected in the sentence in the letter of intent envisaging monetary incentives for teenagers to stay in school. Perhaps a voucher scheme would be advisable in that context.

The high unemployment rate was a cause for serious concern, Mr. Lvin emphasized, although much work remained to be done to identify its causes. Mr. Zoccali had seemed to suggest that the authorities were uneasy with conventional explanations of increased unemployment. In any event, owing to privatization and downsizing of the state, there had been a large transfer of employment from the public to the private sectors, equivalent to up to 10 percent of the labor force. There was much evidence from other countries that a substantial portion of public sector employment could be regarded as hidden—sometimes well-paid— unemployment, maintained at a great expense to taxpayers and with a great loss in transparency. The pre-reform rate of unemployment, in short, was probably higher than had been indicated, meaning that the increase in unemployment since then had been less than indicated. Moreover, he wondered whether the staff knew if there were any differences in regional unemployment relating to varying regional costs of living; it could be hypothesized that persistent, high unemployment was related to centrally mandated and centrally funded unemployment benefits. Such an analysis might help the Board at the next review assess the proposed reform of the unemployment insurance scheme.

If the surprisingly low indicators of compliance with the new private pension system were correct, he wondered how that should be interpreted and how the authorities should be advised to react, Mr. Lvin said. One possible, though controversial, explanation might be found in the inherent contradiction of "Chilean-style" pension reforms, which required mandatory participation in "private" and supposedly mutually beneficial pensions systems. He wondered whether the authorities, by making participation mandatory in the pension system, had systematically misinterpreted the time preference of participants.

He also wondered whether dollarization was as relevant to Argentina as to some other cases, Mr. Lvin stated, but supported Mr. Autheman's request for more staff research in the area, to help the Board assess the currency board system.

The Fund's assessment of Argentine performance during the Stand-By Arrangement might have been biased slightly toward the negative side, Mr. Lvin considered. Even though all performance criteria had been missed, the overriding—although implicit—criterion was the integrity of the currency board, which was not endangered. He fully supported the proposed decision.

Ms. Heinonen made the following statement:

In the six months that have passed since we discussed the Argentine economic program in April, little progress has been made. To characterize the situation, staff has chosen to use the familiar expression, and I quote, "performance under the program has been mixed." The good signs are that economic activity is recovering and inflation remains very low. The bad signs are that fiscal imbalance persists, both at the federal and provincial level, as tax revenue has not grown as envisaged and expenditure controls have been slow to surface; yet the fiscal outcome is one of the cornerstones for the continued success of the Convertibility Plan. External debt and vulnerability to US interest rates seems to be increasing while the debt portfolio has been shifting toward more short-term borrowing. On balance, and against a background of a low score on the January-June performance test, I am not sure the authorities did their homework.

In spite of the apparent shortcomings with meeting the program criteria, the new economic team appear to be committed to the economic program [as evidenced by the launching of a front-loaded package of fiscal measures]. If the spirit of President Menem will prevail, as he has said - according to a recent the Economist article, and I quote, "We will not step off this historical path. We want again to be one of the ten greatest nations in the world," then that kind of spirit will put Argentina on the map. But in the present political mood in Argentina, with a situation of upcoming elections, and against a background of discontent among social partners, actions could be a little more constrained than words.

Nevertheless, during the last Board session on Argentina, we all cautioned the authorities to stand ready to adopt additional measures if needed to stay on the course of adjustment and to persevere in the implementation of structural reform in order to enhance confidence in the performance and prospects of the economy, and that advice is still valid.

To put things in a perspective, Fund credit to Argentina is approaching the cumulative limit of 300 percent of quota this year, becoming the second highest after Mexico. As staff has noted in its latest Review of Access policy and Limits—which we will discuss soon—Argentina is among those middle-income developing countries which, because of growing dependancy on external borrowing and vulnerability to changes in the market sentiment, remain likely to have high financing needs and hence a potential future demand for Fund resources. This is not a scenario which implies a near term graduation from dependency on Fund financing, in contrast to what some of us had hoped for when we approved this Stand-By Arrangement to bridge the period through 1997.

As a way to hedge the bets, however, the staff —in the paper on Access Limits—rightly underscores that under these circumstances a premium is put on prudent macroeconomic and debt management policies, and on member's willingness to implement corrective action as soon as problems begin to emerge. Those guidelines appear at this point applicable for Argentina, and it is with these remarks, and assuming that the authorities have the upper hand in implementing its program, that this chair can give them the benefit of the doubt and agree to the proposed decision.

Mr. Sundara made the following statement:

It is disappointing to note that the performance criteria for end-June 1996 were not met. However, I am encouraged by the efforts the Argentine authorities have recently displayed in their attempt to reduce the fiscal imbalance and reinvigorate the process of structural reform, within the context of the revised program for 1996–97.

Therefore, this chair can support the authorities request for waiver and modification of the performance criteria.

The staff representative from the Western Hemisphere Department said that the authorities had not consulted with the staff on the tax amnesty in late 1995, which had been a subject of discussion at the two previous Board discussions on Argentina. The tax amnesty had achieved mixed results. It had been highly successful in attracting new taxpayers, and subsequent tax compliance had not been below average tax compliance in Argentina. However, the staff was concerned about the amnesty's moral hazard, or the incentive that it gave taxpayers with limited resources not to pay their coming regular taxes in order to benefit from the better terms of the amnesty. While he was not in a position to say whether tax amnesties had been successful in other cases, he would consult with the Fiscal Affairs Department. In any event, the excessive use of tax amnesties was deemed counterproductive.

The value-added tax rate was high by international standards and might have reduced compliance, but its design was no different from that in other countries, the staff representative observed. The authorities were seeking to enforce control of value-added tax invoicing at the retail level, where customers had no incentives to ask for proof of purchase, while retailers benefited from not providing it. Lower sales, in fact, allowed a retailer to deduct proportionately greater costs than if they reported sales accurately; the authorities thus had to provide an extra incentive at the retail level to provide proof of sale.

The credit rating agency was managed and paid for by the central bank, the staff representative indicated. In the past, several attempts had been made to establish private credit rating agencies, but there had been problems with moral hazard, as the banks had influenced the agencies' ratings.

Unemployment was concentrated in Buenos Aires, reflecting migration to the city and changes in the agriculture sector, the staff representative added. The staff had not identified major differences in the cost of living in various regions.

Some provincial banks would not be privatized, including the Provincia de Buenos Aires, the staff representative remarked. In any event, the authorities had privatized the ten provincial banks that the staff had referred to during the March 1996 Board discussion, and an additional one.

The drop in social security contributions was less a problem of participation in that scheme—most registered workers had to join it—than whether both employees and employers actually contributed to it, the staff representative explained. The large social security shortfall in 1995 had been caused by workers and employers who had subscribed to the scheme but were not paying their contributions, mainly because of the recession and the scarcity of credit. The authorities were taking special measures to re-register workers to enforce payment of contributions that were due. It was a similar problem to that of tax evasion more generally, which was why the staff tended to discuss the two together.

The Acting Chairman stated, regarding a question from Mr. Kang on the accountability of staff for realistic program design, that such matters were an issue for management to discuss, and not for staff to discuss with the Board.

Mr. Zoccali said that he could understand Directors' frustration with the authorities' frequent requests for waivers, which had impinged on the credibility of national policies and of Fund conditionality, particularly in the aftermath of the Mexican crisis. Nevertheless, in Argentina's case, the authorities had clearly not abandoned the program's objectives. The combination of needed supply-side reforms in, for example, the area of labor taxes, and the lingering uncertainty owing to the recessionary environment that had prevailed until mid-1996 had impacted on taxpayers' willingness to comply with their tax obligations, including for the social security system, and, therefore, on the government's ability to meet the ambitious fiscal targets that had been agreed with the Fund. The authorities were firmly committed to consolidating sustainable noninflationary growth without backtracking on reform or resorting to one-time-only distortionary measures to close the revenue gap. Instead, the reduction of tax evasion remained a key priority for the authorities. Given the culture of tax evasion and the high value-added tax rate, the incentive for continued evasion certainly remained. However, as Mr. Evans had reminded the Board, the situation was far from dramatic compared with other countries, and required a serious, consistent effort by the authorities to maintain macroeconomic discipline and the momentum of reform.

The sustainability of the authorities' chosen path was tied to the policy constraints derived from the currency board, Mr. Zoccali stressed. He wished to endorse Mr. Autheman's call for further staff research on the dynamics of dollarization in the aftermath of stabilization, keeping in mind that the framework of adjustment chosen by the authorities had been much more than just anchoring the exchange rate; in fact, it had continued to prove its usefulness in remonetizing the economy from the still relatively low levels and in rebuilding Argentina's institutions, as well as the market mechanism in a unique bi-monetary environment. The currency board had been the most effective mechanism for addressing widespread imbalances and allocative distortions that had led to hyperinflation only seven years previously.

Restoring full credibility required a medium-term policy framework, especially in program countries, Mr. Zoccali noted. Occasional slippages should be assessed against the degree of stabilization and resiliency that the economy had gained in successive tests, some beyond the government's control. On both fronts, the Argentine policy stance had again proved to be predictable, being rooted firmly in the widespread belief that the policy mix that had delivered price stability also provided the best opportunity for Argentina's sustainable development.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their commitment to stabilize and restructure the Argentine economy under the difficult circumstances that had followed the crisis in early 1995. Directors were encouraged by the recovery in economic activity that was under way together with the continuing remarkable performance on inflation. They noted the continued strength of exports and Argentina's renewed access to international capital markets which, together with the reflow of deposits, had allowed the rebuilding of international reserves and the improved outlook for the domestic banking system. However, the recovery of economic activity through the first quarter of 1996 had been slow and the high level of unemployment was a major problem. Moreover, Directors were disappointed that all end-June performance criteria were missed particularly the fiscal slippages, with large deviations from program targets, which some Directors considered were ambitious and by the repeated failure in recent times to observe performance criteria under Fund arrangements. While welcoming the authorities' recent efforts at regaining the basic thrust of the program, Directors emphasized that there was no scope for further slippages, within the revised program.
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> On the fiscal situation, the problems with tax evasion and with tax administration underlying those deviations were a cause for concern. Directors stressed that a rapid move toward fiscal balance was essential, not only to ensure the credibility and the sustainability of the Convertibility Plan, but also to reduce the borrowing requirements of the public sector. The still high ratio

of debt service to exports, while declining, heightened Argentina's vulnerability to changes in market sentiment. Directors, therefore, underscored the critical importance of adhering to the program's revised fiscal targets. They welcomed the measures put in place by the new economic team to reduce the public sector deficit in the remainder of 1996 and in 1997, and urged the full implementation of all measures envisaged under the program. Directors noted that the poor revenue performance was the main cause of fiscal slippage, and some pointed out that this had occurred in a context of weak economic activity and structural changes in the pension system. Directors urged the authorities to address the weaknesses in the tax system, including through eliminating tax exemptions and loopholes which made it more difficult to reduce prevailing high tax rates and through implementing institutional changes to improve tax administration, strengthen auditing procedures, and intensify the fight against tax evasion. Some Directors called for a reform of the tax system, including the value-added tax, and a broadening of the income-tax base. Some also cautioned against reliance on ad hoc revenue measures, including the increased tariff on capital goods. Directors emphasized the need for continued restraint over public expenditure and for better targeting of social spending. They also encouraged the authorities to give priority to provincial finance reform to ensure the success of fiscal consolidation.

Directors noted the importance of regaining the momentum of structural reform to enhance economic efficiency, raise domestic saving and investment, and promote faster growth of output and employment in the context of balance of payments viability. Directors welcomed the proposals now before Congress concerning reforms of the labor market and the union-based health care system. They stressed the urgency of those reforms, which were needed to enhance the flexibility of labor relations, reduce labor costs, and remove disincentives to employment. Labor market reforms were also crucial to ensure Argentina's competitiveness an issue of concern to some Directors and held the best promise for putting the economy on an investment- and export-led high growth path over the medium term that would help resolve the difficult unemployment problem and sustain public support for reforms. More generally, Directors attached priority to further progress with the reform of the administrative structure of the federal government, including the social security and health-care systems, and completing the privatization drive.

Directors noted the progress in restructuring the domestic banking system, and welcomed the return of confidence as reflected in the recovery of bank deposits. Enhancing confidence in the banking system was essential to reduce intermediation spreads and to help boost private investment. Directors commended the authorities for their steadfast pursuit of sound banking practices and the gradual strengthening of prudential regulations. The implementation of additional liquidity and capital adequacy requirements, together with the establishment of a contingent credit facility to help in the event of a sudden system-wide liquidity need, had greatly reduced systemic risks in the banking system. Some Directors urged the authorities to conclude expeditiously the process of privatization of provincial banks.

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

The Executive Board took the following decision:

1. Argentina has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Argentina (EBS/96/45, Sup. 1, 4/15/96) and the second paragraph of the letter dated March 14, 1996 from the Minister of Economy and Public Work and Services of the Republic of Argentina, to review progress in realizing the objectives of the program supported by the Stand-By Arrangement.

2. The letter dated September 16, 1996 from the Minister of Economy and Public Work and Services and the President of the Central Bank of the Republic of Argentina with its annexed policy memorandum and table shall be attached to the Stand-By Arrangement for Argentina, and the letter dated March 14, 1996, with its annexed policy memorandum and table shall be read as supplemented and modified by the letter dated September 16, 1996 with its annexed policy memorandum and table.

3. Accordingly:

(i) references in paragraph 3(a) of the Stand-By Arrangement to Table 1 of the memorandum annexed to the letter dated March 14, 1996 with respect to the quantitative performance criteria for end-September and end-December 1996 shall be to Table 1 of the memorandum annexed to the letter dated September 16, 1996; and

(ii) paragraph 3(c) of the Stand-By Arrangement shall be amended to read as follows:

"(c) after August 31, 1996, February 28, 1997, July 31, 1997, and November 30, 1997, until the respective reviews contemplated in the second paragraph of the letter dated September 16, 1996 are completed; or."

4. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement is completed and that, notwithstanding paragraph 3(a) of the Stand-By Arrangement, Argentina may proceed to make purchases under the arrangement for up to the cumulative amount of SDR 185 million until December 1, 1996.

Decision No.11369-(96/98), adopted
October 30, 1996

3. ENHANCED STRUCTURAL ADJUSTMENT FACILITY—EXTERNAL EVALUATION

The Executive Directors considered a report by the Evaluation Group of Executive Directors and its proposals for an external evaluation of certain aspects of the Enhanced Structural Adjustment Facility, including proposals for terms of reference, the selection of experts, and a budget (EBAP/96/103, 10/16/96).

Mr. Clark made the following statement:

> First off, I would like to thank my colleagues—Ms. Guti, Mr. Mirakhor and Mr. Wijnholds—for their work as members of the Evaluation Group, and, indeed, to the many other colleagues who contributed to the discussions in the Evaluation Group on this issue. I am also very grateful for the support given this initiative by the Managing Director as well as the assistance and advice provided by staff in the office of Internal Audit and Inspection, in the Policy Development and Review Department and in the Secretariat.
>
> I would also like to particularly thank the First Deputy Managing Director in agreeing to the Evaluation Group's request to help us in his personal capacity to prioritize the list of potential evaluators identified by Executive Directors. I am very happy with the quality of the four experts who have agreed to participate.
>
> I might also say that, while the Managing Director did not object to the terms of reference, he did raise his eyebrows at the $600,000 price tag. Although the Evaluation Group has been persuaded that the study will cost about this much, given the experience with recent evaluations. I suspect you will hear more about this $600,000 in discussions with management around next year's administrative budget.
>
> I will not take up the Board's time by summarizing the proposed terms of reference given that we have all had time to review them. I should note that, if we agree to the Terms roughly as proposed, the Board will not need to turn its attention to this issue again until presentation of preliminary findings late next year. Instead, we could turn our attention to identifying the subject of the next external evaluation. You recall that, for example, interest was expressed in a review of the appropriateness of performance criteria used in Fund programs. The experience with the ESAF evaluation suggests that it will take several meetings of the Evaluation Group and perhaps several months to select the topic and finalize the terms of reference. This could usefully begin next week.
>
> But that will be for others. Let me instead turn to the project at hand.
>
> In some ways, it was unfortunate that the first external evaluation project to be handled in this new process was such a major topic. It might have been nice to have been able to "cut our teeth" on something less controversial than the question of ESAF effectiveness. It will not be news to anyone around

this table that ESAF, as the main mechanism through which the Fund addresses the needs of lower-income countries and now, as the centerpiece of the Fund's participation in the HIPC Initiative, is increasingly being scrutinized from a wide range of perspectives. Many donor governments, faced with competing demands for scarce concessional resources are having to justify funding allocations on the basis of relative effectiveness. Compounding this is pressure from a growing number of politically-astute NGOs, many of which are becoming increasingly vocal.

Clearly, this was not the simplest topic we could have chosen for study and we can expect that the work we commission will be closely scrutinized. My authorities in Ottawa and the staff in my office here have already begun receiving calls from outside organizations requesting details on the scope of the ESAF evaluation and information on who will be consulted during the study. I know others around this table have received similar enquiries.

One approach would be to agree to a press line that would be attributable to me as Chairman of the Evaluation Group. This line would be used by External Relations in response to questions from the media.

Mr. Anjaria and I have worked up some lines which summarize the basic facts. If we agree to these lines, or others, I could have these circulated to Board members for their use in response to calls in their offices.

An argument could also be made for a more pro-active approach—one which would more actively seek to spread the word about what is a promising undertaking by the Fund. This would entail, after agreement on the terms of reference has been reached, the issuance of a press release announcing the launching of an independent evaluation of ESAF. It would highlight that the evaluation is being undertaken in an effort to improve the effectiveness of Fund programming and it would draw attention to the specific terms of reference, particularly with respect to the study of how social indicators have evolved in countries undertaking ESAF programs.

Given the potential for the terms of reference of the study to find their way out to the press, the Fund's public image might benefit from a more proactive communication strategy. Our decision to undertake this external evaluation of ESAF effectiveness, I believe, sends a strong and positive message about this institution's receptiveness to constructive criticism. Having decided to proceed with this evaluation, we should give some thought on how to maximize its benefits.

I would be interested in hearing the views of my colleagues on this matter.

The Chairman said that he hoped that the secondary issue of whether to publicize the evaluation would not be the focus of the Board's discussion. While it was not the first time that the Fund had used external experts to evaluate its activities, the fact that it was currently doing so in respect of a major Fund instrument suggested the need for caution regarding publicity: the four evaluators needed to be able to do their work and to organize their contacts with external sources without interference by or pressure from the press or nongovernmental organizations. At their own initiative, they could contact experts from the latter. When they submitted their evaluation report, the Board could then decide whether to publish their conclusions and to engage in a public dialogue.

Mr. Fremann, speaking on behalf of Mr. Autheman, made the following statement:

> I can endorse the proposed topics for evaluation, recommended by the Evaluation Group, and I would like to thank Mr. Clark, Mrs. Guti, and Messrs. Mirakhor and Wijnholds for their personal contributions to this new endeavor.
>
> I have two comments:
>
> I am concerned that the terms of reference for the second topic (social policies and the composition of government spending during ESAF-supported programs) may ignore the important work already undertaken by the World Bank. Almost all, if not all, ESAF programs are accompanied by IDA adjustment credits, which are aimed more and more at addressing the social dimension of adjustment. The Operations Evaluation Department of the World Bank published in June 1995 a comprehensive study on "the social impact of adjustment operations," based on 144 adjustment operations in 53 countries (both IDA and IBRD borrowers), approved between 1980 and 1993. Some questions raised by the proposed terms of reference (evolution of social spending, safety nets) are addressed in-depth by this report (especially chapters 4 on "Public spending to reduce poverty" and 5 on "Social safety nets to temporarily reduce poverty.")
>
> The question "To what extent have Fund staff collaborated with other institutions that have expertise on social issues?" should be given more prominence in the overall approach of this evaluation. Any evaluation commissioned by the Fund should be designed and conducted in accordance with the agreed division of responsibilities between the Fund and the World Bank. It should also take into account the existing instrument of cooperation between the two institutions. I am referring in particular to the policy framework papers.
>
> I therefore suggest that we should be ready to redesign the terms of reference of this topic, in order to refocus it within our own mandate. This implies that we draw on the expertise accumulated by the World Bank; prevent any repetition of existing studies; and place the emphasis on the assessment of the quality of our cooperation with the World Bank: did our conditionality impede or help the attainment of its own objective by IDA (lasting reduction in poverty), which all of the members fully support?
>
> I assume that the other important issues will be covered by the Policy Development and Review Department in its internal review. As Mr. Fayolle stated during the discussions of the Evaluation Group, we consider that the evaluation of the inflation performance should be an essential component of the internal review, since the persistence of high inflation has been, as pointed

> out by the last the Policy Development and Review Department's review, a frequent failure of ESAF programs. I would appreciate confirmation that this topic has been added to the items noted by Ms. Schadler at the September 5 meeting of the Evaluation Group and is now considered by the Policy Development and Review Department as one of the key components of its own evaluation.

Mr. Fremann, extending his remarks, said that he certainly favored holding a seminar with the external evaluators, where some of the points raised in his statement could be addressed as well.

Mr. Sivaraman made the following statement:

> I am grateful to Mr. Clark and other colleagues who have incorporated all my suggestions in the terms of reference. I have a few more comments. The report of the Executive Directors on their visit to Egypt, Jordan and Yemen is revealing. It gives a candid view of the public perception or misconception of the Fund-sponsored programs. While our programs are normally designed to achieve fiscal consolidation, exchange rate stability and overall macroeconomic balance with a view to achieving sustained growth in developing economies, for some reason, these are viewed with suspicion by certain sections of the people there. In fact they are more often perceived as programs designed to cause hardship to the poor. It is necessary for the evaluators to find the reasons for such a perception in the program countries whether it is born out of a misunderstanding of the programs, or on account of their improper implementation—or whether some of the programs could have been better designed to cause less hardship. Is there also a need for a proper public stance of the Fund in these countries before a program is launched? Is it necessary for missions to make their consultations more broad based before they submit their report?
>
> A large number of NGOs met me during the Annual Fund Bank Meetings. They seemed to be laboring under a belief that our conditionalities are harsh. I had to explain that they would seem harsh after a period of fiscal profligacy and that anywhere observance of a strict fiscal and monetary discipline may be scorned at first but it would be necessary to put an economy back on track. I am afraid they were not convinced.
>
> While briefing evaluators these points have to be brought to their notice so that they can find out why such impressions are there despite the fact that logic, theory and practice would generally support most conditionalities of the programs.
>
> After evaluators have selected the countries for their studies, it may be necessary for the Fund Management to get the full support of the respective governments for the studies to be conducted if necessary in the countries as evaluators may like to get the views of organizations, parliamentarians, NGOs and other representatives of people.

On the question of national ownership of programs we should be clear as to what we mean by national ownership. Do we mean that the programs were fully acceptable to the countries for implementation or they had no choice but to accept them under a given set of circumstances? In Federal States, I believe, I hope I am wrong, the Fund missions generally do not discuss programs with federating units. In these countries fiscal deficit may be partly under the control of the States or provinces who enjoy autonomy in regard to taxes and expenditure. Under such circumstances, could it be said that the Fund missions have completed consultations for finalizations of report if they had no opportunity of knowing states/provinces views on program related matters.

Evaluators have to look into these aspects and give their suggestion as to how best this problem can be tackled to make staff consultations and consequent recommendations more broad based.

The Chairman remarked that one of the conclusions of the evaluators might well imply including an External Relations officer on Fund missions to ensure that the Fund's work in the country was better understood. However, that could have significant consequences for the Fund's budget. Part of the Fund's problem was related to the fact that the Fund had limited funds for trying to improve its image.

Mrs. Farid made the following statement:

We welcome the opportunity to discuss the proposed terms of reference for the external evaluation of ESAF and would like to express our appreciation for the hard work undertaken by Mr. Clark and the members of the Evaluation Group, as well as by the staff. While understanding the difficulties which the group encountered in achieving consensus on the wording of the terms of reference, we must confess, however, that in our view the questions are not always spelled out in a sufficiently clear manner and as a consequence the proposal does not provide sufficient guidance to the evaluators in some areas. We therefore strongly support the idea of the proposed seminar and would underscore the importance of focusing the seminar on, among other things, adding clarity to the terms of reference so that we may avoid any disappointments when the final result is presented to us.

Turning to specifics:

Not surprisingly, the terms of reference for the first topic in the evaluation are the clearest since they deal with a concept that is very much part of the Fund mandate and on which Fund staff have already done much work.

We have only two remarks on this topic:

a) On the 3rd bullet point—which deals with possible explanations of divergences from what was expected in a country's external position in successive ESAF supported programs—we assume that divergences could occur for many reasons, among which are: overly optimistic targets or poor program design. We hope that these will be among the factors considered in attempting to explain divergences from program targets.

b) Our second remark deals with the 4th bullet point, namely the question on whether the evolution of a country's external position had been consistent with progress toward sustainable growth. It is not clear what is meant here, and we would appreciate some explanation on what is to be studied here. Points which come to mind are whether the buildup of reserves as a policy objective had hindered the program's growth objective, or conversely, whether a weak external position had been a constraint to growth? Is this what is meant here? or are there other points which the authors had in mind? We are not proposing that we dictate to the evaluators what they should be looking for, but rather suggesting a clearer definition of what is to be studied.

Turning to the second topic, namely social policies and the composition of government spending in ESAF programs:

We very much welcome Mr. Autheman's remarks on this topic and agree that we must be careful not to repeat work done by the World Bank. Given the information he just provided we would agree that there is a need to redesign the terms of reference on this topic with the objective of focusing it within our own mandate. Thus clearly we need to look again at the questions on social safety nets, social indicators and social policies. Before reading Mr. Autheman's statement we also intended to express reservations with regard to the question on the effectiveness of social safety nets and we were also unsure of the intent behind the question on the appropriateness of Fund advice on social safety nets, social indicators and social policies.

Having said that, we would like to emphasize the importance of the questions posed in the fifth bullet under this topic, which we believe do fall under the Fund's mandate and express our expectation that they would provide us with the evaluators' judgment on the appropriateness of the balance struck between deficit reduction and social spending levels in the programs concerned. To what extent were decisions on the level of social spending influenced by the desire to reach a specific deficit target? Or vice versa, to what extent was the decision on the specific deficit target influenced by the need for social spending? What were the consequences of the choices made? Were there instances of programs coming off track because adjustment was so strong and programmed levels of social spending so inadequate that authorities felt compelled to abandon the program. If there were in fact cases like that, or simply cases where severe social crises erupted as a result of program implementation, could that have been avoided? Are there any implications for the design of Fund programs? Or should such consequences be taken for granted as unavoidable costs of adjustment? We hope that the evaluation will shed light on these important issues, but we are not certain that the phrasing of the terms of reference does indeed cover these issues..

We also see merit to including an assessment of the effect of ESAF programs on unemployment in the terms of reference. This could be included in the question in the sixth bullet which asks if there is any evidence on changes in social conditions or "other economic outcomes" in countries that have persevered with adjustment under ESAF supported programs? We are not sure what "other economic outcomes" are being referred to here. In any case we would suggest that unemployment be specifically included. If we have other outcomes in mind we should also spell them out.

Turning to the third topic, while we agree that program ownership is very important, it is a difficult concept to define and assess. We therefore feel that it is extremely important that we come to at least a preliminary understanding, in the proposed seminar, on the elements that could constitute the answer to the first question posed here, namely "on what criteria can national ownership of an ESAF-supported program be assessed?" In this connection, we hope that the phrasing of the section on the organization of the seminar, on page 9, does not preclude this. Our specific concern is with the part where it says "his session will not give direction to the evaluators." It is important that we clarify what we mean here, since it is our understanding that in fact the seminar would do precisely that, namely, give direction to the evaluators in those areas where the terms of reference are not quite clear. We would appreciate staff views on this issue and whether the wording is appropriate.

Still on the ownership topic, we also feel that the evaluation should attempt to determine if there were elements in the design of ESAF programs that seemed to affect positively or negatively the sense of national ownership.

We would also point to the possibility of the existence of linkages among the three topics being evaluated. We can conceive, for example, of possible linkages between social spending issues and the ownership question. There may be others. Perhaps we should include something on the linkages between the three topics in the terms of reference.

Finally, we have a question on Item 6 of the proposed terms of reference. We are not altogether clear on what is meant by point 1, namely that the evaluators are invited to prepare their report on the assumption that it would be published by the Fund? How would the report preparation differ if it were prepared without this assumption? Our concern here is that the candor with which the report is written not be compromised in any way.

To conclude, we can agree to the choice of evaluators and the other points on selection of case studies, evaluators' access to information, resources, timing and monitoring. We also agree that the seminar discussion may reveal the need to modify some parts of the terms of reference and that this should be done through a recommendation from the Evaluation group to the Executive Board.

The Chairman expressed the hope that Directors' comments would not lead to a reopening of the discussion on the terms of reference.

Mr. Clark added that he would expect the evaluators to look carefully at their broad terms of reference and to draft a report covering the important issues. It would not be helpful for Directors to focus at the current meeting on the fine points of the terms of reference themselves.

The most important factors for ensuring successful evaluations were to hire the most qualified evaluators and to ensure harmonious relations among them, Mr. Clark emphasized. The Fund had done well on both counts: the evaluators would draft three independent chapters, which would allow them to provide their best advice, without duplicating each other's work. At the same time, they would have to work with each other, and provide coherent, overarching conclusions. The proposed terms of reference made it clear that the evaluators' client was the Executive Board, which was important as well. The Evaluation Group had suggested that the evaluators participate in a seminar with the Board, to enable them to gain a better sense of the terms of reference and of their client.

The Evaluation Group was in basic agreement on the thrust of the terms of reference, and it was important to proceed to the next step, to let the evaluators begin their work, Mr. Clark considered. The Evaluation Group would monitor the work of the evaluators. The evaluators would be asked to listen carefully to the full range of Directors' views at the seminar, and to take them into account in their work. Directors' current task was to indicate whether they broadly agreed with the Evaluation Group's proposals.

The Chairman remarked that Directors should not seek to redraft the terms of reference. The seminar would be a good opportunity for Directors to inform the evaluators of their views. It was up to the evaluators then to proceed as they saw fit, within the broad guidelines of the terms of reference.

Mr. Daïri said that he nevertheless hoped that the points raised by Mrs. Farid about publication of the evaluation could be taken into account

The Chairman responded that, as highly regarded professionals, the evaluators would not allow the possibility that the Fund might publish their work to affect the candidness or quality of their evaluation. To allow that would jeopardize their own credibility. The Board had the option of deciding whether or not to publish the report after its submission.

Mr. Mesaki made the following statement:

> First of all, I was pleased to see the proposal on external evaluation of the ESAF, which was made by the Evaluation Group members following constructive discussion within the Group. I commend Mr. Clark for his strenuous efforts as group Chairman as well as the staff for its efforts in this regard.
>
> The proposal is the result of extensive discussion among the Evaluation Group and interested Directors, including me. I therefore support it. I would just like to make a few comments, for emphasis, and to ask a few questions of the staff.
>
> As many Directors insisted at the Group meeting, it is crucial that the external evaluator remain independent of the staff and authorities concerned.

In this respect, the staff's review of draft evaluation reports should be strictly limited only for the purpose of ensuring confidentiality. On the issue of publicity, I share the Chairman's concern that we should be very careful.

With regard to publication of the report, although this will be decided later by the Board, my position is that these reports should be published, as was true of the past ESAF evaluation.

The proposed terms of reference clearly show that one of the main purposes of this evaluation is to draw operational conclusions for future programs. In this sense, the reports should not be excessively abstract or theoretical but, rather, should contain practical suggestions.

Finally, let me turn to the relationship between the HIPC Initiative and the Policy Development and Review Department's internal evaluation. The summing up of the September 18 Board meeting states that "The staff has already initiated a review of ESAF-supported programs, which is intended to be discussed by the Executive Board in the spring of 1997. On that occasion, the staff will also examine conditionality under ESAF arrangements, including the possibility of linking disbursements to quarterly performance criteria, and it will provide concrete suggestions for the Board to consider." In this connection, I would be grateful if the staff would describe to me the contents of the internal evaluation which includes consideration of this matter. Furthermore, I am wondering about the timing of the staff's submission of concrete suggestions for strengthening conditionality, which will possibly include linking disbursements to quarterly performance criteria. Will the staff make proposals based only on the results of the internal evaluation, or will they not make a proposal until the submission of the unified conclusions of the internal and external evaluations?

Since the HIPC Initiative is now at the implementation phase and since some of the possible candidates are approaching a decision point, I would like to stress the importance of early consideration of strengthening the conditionality of ESAF for the second stage.

Finally, let me again thank Mr. Clark for his great dedication and contribution. I wish him good luck in his new career.

Mr. Newman made the following statement:

I will try and be brief, as you requested. We see this outside evaluation as being very important as a means of improving the effectiveness of the ESAF, of helping to build support for the ESAF, especially at a time when we are seeking additional resources for it, as well as enhancing the transparency of the Fund and, therefore, building support for the Fund amongst the public, similarly at the same time that we will be seeking additional resources for the Fund. It is for these reasons that we believe it is extremely important that the Fund take the opportunity to inform the public of what we are doing in the context of this evaluation, and we believe that this can best be achieved through a press release that describes the scope of the evaluation and the specific topics that will be examined. We might want to leave it to the evaluators whether or not their names are included in the press release in order to protect some of their privacy as the Managing Director suggested, although to be perfectly frank I am fairly confident that their names will get out, if they are not already out, in the public domain within a relatively short period of time. I think this is also particularly important so that we do not create false perceptions about what we are doing. The world does know that we are about to undertake an evaluation, we are already getting inquiries on this matter, and I think it would be a mistake if we did not respond to those inquiries in a forthcoming manner. This is especially important since our colleagues across the street are about to engage in a similar exercise that is very open to the public, has been publicized, and that will actively involve the public in its own deliberations. It would contrast very strangely if they were to go one route and we were to be going another route, particularly if we are not going to be actively participating in the World Bank study of the impact of the structural adjustment programs.

As the issue of the evaluators' relationship to the Policy Development and Review study has been raised, I also have a question. I think it is very useful that we do get the second opinion of outside evaluators on the Policy Development and Review work, but it was not clear to me how exactly such a second opinion would be provided to the Board, particularly as the Policy Development and Review Department work is going forward on a somewhat different schedule than that of the outside evaluators. We will be discussing the Policy Development and Review Department study next spring, and the outside evaluators' report is not scheduled to be provided to the Board until toward the end of the year. Therefore I would appreciate some indication about how the Board will get an opportunity to share the outside evaluators' views in a timely manner for our spring deliberations.

I will not comment on the terms of reference. I am broadly satisfied with them. Any comments we want to make can be done at the seminar. I also expect that good evaluators—and I think we have good evaluators—will use the terms of reference to achieve their own purposes, and almost certainly will do a broader examination than any of us probably contemplate in the terms of reference.

I do have few comments on one particular issue, and that was with regard to Mr. Autheman's suggestions. While I certainly am sympathetic to the idea of avoiding overlap with the World Bank and believe that the terms of reference provide the evaluators with ample scope to draw on the World Bank's factual material, I do not think we should circumscribe their efforts to solely look at the question of whether or not the Fund and the World Bank are collaborating with one another. We have programs that we are responsible for, that use particular instruments, and have specific purposes that can have a unique impact on government expenditure and social policies, which the evaluators should look at independently of the World Bank and in the context of our own programs.

> Finally, with regard to this proposed seminar with the evaluators in January, I think this is an excellent idea to provide them with the views of the Board on their work program.
>
> I note the seminar is to include outside experts, as well, in order to provide a commentary on what the evaluators intend to do and how they intend to go about their work. I would hope that the seminar would be an open one so that we could include people from the NGO community who are experts in some of the issues that the evaluators are going to be looking at. I would hate to exclude groups like that simply because they have been critics of the institution.

The Chairman stressed that his preference was that consultations with nongovernmental organizations should take place later and in a different way. Drawing parallels between the World Bank's and the Fund's procedures for evaluations was inappropriate. The World Bank's evaluation mandate differed from that of the Fund, and the relationship between the Bank and nongovernmental organizations was also different from the Fund's relationship with them.

The evaluators should not be subject to attack from nongovernmental organizations, the Chairman commented. The latter's criticisms were not always balanced with constructive suggestions; also, they had far less to say about the Fund than about the Bank. To ask evaluators to meet with nongovernmental organizations before they had begun their work would not help them to draft a report of the sort that the Board wished, one that would improve a key instrument of the Fund.

Mr. Donecker made the following statement:

> We welcome the efforts to strengthen the evaluation function in the Fund. We hope that the proposed external evaluation of ESAF will provide new insights into the working of the ESAF instrument and also provide a basis to improve the ESAF with the objective of enhancing its efficiency. In this context, we are of course also looking forward to the Review of the ESAF by our own Policy Development and Review Department.
>
> Regarding the relationship between these two evaluations, both staff's review and the external evaluation should be complementary. Both groups should try to minimize duplicating each other's work, although there will be unavoidable thematic overlaps. This notwithstanding, the two evaluations from both internal and external experts on the same topic will provide the unique opportunity to evaluate the respective merits of this two-pronged approach—and thus of our still very new evaluation concept.
>
> The terms of reference for the external evaluation deal with a broad range of aspects of the ESAF. This comes as no surprise, given the different views and interests among member countries. Our colleagues Ms. Guti, Mr. Clark, Mr. Mirakhor and Mr. Wijnholds did good work in trying to balancing these different points of view. I would like to thank them for their work, their spirit of cooperation and their patience in dealing with many comments and suggestions during the prelude to our meeting today.

On specific aspects of the terms of reference, let me briefly touch upon the second main topic of the external evaluation agenda: social policies and the composition of government spending during ESAF-supported programs. In our view, the bullets under the topic focus too much on social issues, while the other part of the heading—the composition of government spending—is only barely recognizable. In this context, we are, in particular, missing a clear reference to unproductive expenditures and their influence on ESAF-supported countries' overall economic performance as well as on the individual governments' room for cost effective special measures designed to protect the poor.

We leave it to the external evaluators to decide in which logical sequence they want to tackle the various aspects of their individual topics. Suffice it for me to say here that the order of bullet points, in my view, does not automatically reflect the importance of the various aspects of a particular topic. With regard to the social policies and composition of government spending topic, for instance, I would see particular merit in getting the external evaluation's view on the penultimate bullet points, i.e.

To what extent have Fund staff collaborated with other institutions that have expertise on social issues? Has such collaboration been fruitful and how can it be enhanced?

Here I have noted with interest and surprise Mr. Autheman's remarks in his statement about similar research already carried out by the World Bank. I fully concur with his position that any evaluation commissioned by the Fund should be designed and conducted in accordance with the agreed division of responsibilities between the Fund and the World Bank. I therefore support his and Mrs. Farid's suggestion, that we should be ready to redesign the terms of reference of this topic in order to refocus it within our own mandate. This implies that we draw on the expertise accumulated by the World Bank and prevent any repetition of existing studies. For this we need to know the exact range and results of the World Bank studies mentioned by Mr. Autheman.

So I am afraid that this particular part of the evaluation project needs further study and discussion by this Board before we can give the green light for this project. At a minimum these issues should be taken up in the context of the proposed seminar. This seminar should not be open to other parties. This is an evaluation of the Fund's board.

In addition, in the light of the recent Interim Committee Declaration—Partnership for Sustainable Global Growth—it also appears worthwhile to include the issue of corruption in the analysis.

I also note that the issue of prolonged ESAF use and the related question to what extent the various changes in the ESAF instrument since its inception may have contributed to weaken individual governments' resolve to implement their structural adjustment programs under the ESAF decisively is not sufficiently covered by the external evaluation topics. After all the issue of prolonged ESAF use was explicitly included in the concluding remarks of the

Managing Director at our previous Board discussion of the ESAF evaluation project in June this year. We firmly expect that these issues, will be given at least serious consideration in the Policy Development and Review Department's review of the ESAF. In this context, staff should analyze if and to what extent a softening of the ESAF instrument, such as the move to sequential arrangements and the Fund's willingness to continue with an ESAF-arrangement after a prolonged interruption, has contributed to a lack of discipline and thus possibly severely impeded the adjustment process.

As we have made clear during the committee's discussions we would have preferred a stricter focus of the external evaluation on those ESAF issues that are directly related to the Fund's mandate and thus of particular importance for the Fund. We would like to encourage the Policy Development and Review Department as well as the external evaluators to remain aware of the special objectives of the ESAF and of its special position in the context of the Fund's range of instruments for financial assistance.

With regard to the question of a possible publication of these ESAF evaluation reports I want to stress that these reports are first and foremost meant for the use of this Board, the Fund management and staff and for our authorities. This whole expensive and time consuming exercise is only justifiable if we get frank, candid, objective and unambiguous answers from our commissioned experts—and not some diplomatically phrased reports that are geared for consumption by the general public. We should decide on a possible publication of these papers after we have digested and discussed them. So let us encourage the external and internal evaluators to give us their frank and honest opinion on the working of the ESAF. Then, after our discussion of their findings we can decide if and in what form we want to go ahead with a publication. Having said this, I would prefer a short press guidance for our external relations department simply stating that the Board has started this evaluation. I support you, Mr. Managing Director in your call for caution in this matter here today.

Mr. Barro Chambrier made the following statement:

I very much welcome today's paper which makes proposals for an external evaluation of ESAF, as well as the terms of reference.

Before commenting on various aspects of the proposals, let me first commend the Evaluation Group of Executive Directors for their work and for their efforts in producing today's paper. My special thanks to Mr. Clark who has made such an important contribution to these efforts and for allowing us to benefit once more, before he leaves, of his knowledge and expertise.

On the different aspects of the proposals, I would like to say that overall, I am in broad agreement with the terms of reference being proposed. However, I would like to offer the following comments:

First, on the Purpose of the Evaluation, I agree that the aim should be to evaluate the effectiveness of certain aspects of program design with the objective of making recommendations that will improve the facility. This is very important due to the uneven success we have had with ESAF, although, there is no doubt about the benefits of the facility and its basic objectives. With a different perspective, the evaluators might be able to come up with useful recommendations that can improve the design of our program.

Second, on the Structure and Form of the Evaluation. Here while I agree with the topics chosen, I would have preferred to see more emphasis put on the assessment of the ESAF instrument in meeting the objectives set, especially the growth objective. In view of the divergent growth performance of countries under ESAF, I think that an assessment of the main factors that explain the different growth outcomes could be extremely helpful in improving our programs.

Another related issue that also merits consideration is that of structural reforms. Many times the objectives of structural reforms have not been achieved although the reforms were undertaken. In view of the impact of structural reforms on the level of investment, savings and employment creation, I think that this may be an area where the evaluators could help us to understand better the linkages and the impact of these measures. Concurrently, this could help us to understand whether our growth model is consistent with the objectives we are setting.

Turning to the three issues being proposed for evaluation. Under the first topic. When assessing the causes of external vulnerability, I would hope that attention will also be given to the issue of external debt, its effect on the adjustment process and in what ways it has prevented the achievement of external viability.

Under the second topic of social policies, most of the issues which are of concern to us are adequately addressed, and I can go along with the proposals.

Under the third topic of program ownership, I would like to suggest the addition of another issue, which is to what extent has the lack of trained personnel in economic management and policy-making been a consequence of weak ownership of programs and a cause for weak implementation. This is an issue that has not been properly addressed under our programs and I think that a better understanding of this problem can help us to better design our program, and prevent slippages. Additionally, I would suggest that the evaluators assess how successful ESAF programs have been in strengthening human resources and thus help to improve program implementation.

Finally, I fully support the idea of holding a seminar which could better clarify the terms of reference.

Mr. Kaufmann made the following statement:

We warmly welcome the proposal of an external evaluation of some key elements of ESAF. Notwithstanding the high quality of the regular in-house reviews, we are convinced that this external evaluation will provide valuable additional insights on current operations under ESAF. A credible and unbiased evaluation is especially important under the current circumstances. With over thirty ongoing ESAF programs and a clear decision of the Interim Committee to maintain ESAF as the main instrument of Fund involvement in low-income countries, it is crucial that the Board can fully support the design and implementation of these programs.

As to the proposed terms of reference, we fully agree with the three issues that were chosen. The first issue touches upon the one of the "raison d'être" of ESAF, since attaining a viable external position is a major goal of ESAF-supported programs. Given the uneven track record of ESAF beneficiaries in this area, precise knowledge of the impact of ESAF-supported programs on the external position should help improve future programs.

We also look forward to the results on the issue regarding social policies and the composition of government spending during ESAF-supported programs. In most cases the stability and sustainability of economic and social development depends crucially on social conditions such as inequality and access to education and health services. The evolution of such social indicators are themselves determined by the level of public expenditure and investment in the relevant areas. Given the precarious financing situations in most program countries, these expenditure categories often come under severe pressure. Therefore, a careful assessment of how social conditions are influenced by ESAF programs is important. Since ESAF programs are embedded in medium-term policy frameworks and strongly involve bilateral donors, the results in this area will also be useful to help donors formulate bilateral cooperation programs and projects.

The issue regarding the national ownership of ESAF-supported programs is—from the operational point of view—surely the most daunting. Although most actors in the field of development financing agree that strong ownership is a crucial factor for the degree of success of an adjustment program, judging the degree of ownership is extremely difficult. We welcome the inclusion of this issue in the evaluation, because we are convinced that fundamental reforms included in most ESAF programs cannot be implemented efficiently and sustainably without a broad-based support of the population. Therefore, a deeper understanding of how the Fund has tried to obtain such a widespread commitment to adjustment programs is necessary. A delicate question in this area is how far the staff can go to ensure participation of all relevant groups, while not infringing upon the rights of sovereign nations.

Finally, we particularly welcome the fact that it is envisaged to make the report available to the public. On Mr. Clark's suggestion to issue a compre- hensive press release at this stage of the evaluation exercise, we tend to share the Chairman's opinion that the evaluators should be protected against pressure groups as much as possible during their research; a short note to the press might thus be more appropriate. However, we assume that once the study is concluded the Fund will enter into an extensive discussion with the interested segments of the public.

Mr. Han made the following statement:

At the outset, I would like to join my colleagues in expressing our thanks to the Evaluation Group and the staff from the Office of Internal Audit and Inspection and the Policy Development and Review Department for their hard work in preparing the concise documents for today's Board discussion. In particular, our appreciation goes to Mr. Clark for his excellent Chairmanship of the Evaluation Group which has greatly enhanced its efficiency.

We expect that an evaluation of the major ESAF aspects by independent external experts would bring an objective assessment on the productivity of this important Fund facility directed to assist its low income members. Their recommendations for improving the ESAF instrument with regard to its design and implementation will strengthen the Fund in its efforts to serve its objectives. In this connection, I believe, it is very important to provide the full capacity that the external experts, at their complete discretion, may conduct their evaluations on their own judgment and without any outside interference. This is the very reason why, to my mind, the Executive Board would expect this exercise to be productive.

This chair supports the recommended decision on the approval of the terms of reference of the external evaluation of ESAF dated October 16, 1996 as presented in today's report.

Mr. Guzmán-Calafell made the following statement:

First of all, I wish to join previous speakers in commending the members of the Evaluation Group for the efficiency displayed in delineating the terms of reference for the external evaluation of the ESAF. The work carried out by the Group is particularly meritorious in view of its creative nature and the short time span in which it was completed. I am sure that this effort will represent an important point of departure for any future work in this area.

The proposed terms of reference concentrate on three aspects which are of great relevance for ESAF supported programs. The experts selected are clearly well qualified to perform this job, and they are provided with the degree of independence and access to information required to carry out this task in an efficient way. Similarly, the responsibilities of the evaluators are well defined and in general the rules of the game clearly stated. In sum, I am in broad agreement with the proposed terms of reference, and therefore I will limit my intervention to one remark.

It is widely agreed that the ultimate objective of economic policy is the attainment of adequate rates of economic growth. However, like Mr. Barro Chambrier, I note that this issue does not represent the central focus of attention in any of the topics considered under the evaluation. It is true that economic growth is contemplated either implicitly or explicitly in some of the topics selected. More specifically, the issue of economic growth is undoubtedly present when considering developments in countries' external positions and social policies. But, I am concerned that this might constitute a somewhat indirect consideration of the impact of these programs on economic growth. I believe that, if this were the case, we would be missing an important opportunity to have an external and well-informed judgment of the extent to which Fund programs under the ESAF meet this central objective. It is worth noting in this connection that an important message of our last review of conditionality was that no country moved to a clearly more rapid pace of economic growth during the period that followed the implementation of Fund supported programs. I believe that this issue can be addressed within the proposed terms of reference by explaining clearly to the evaluators this concern.

Mr. Prader made the following statement:

Following Mr. Ismael's advice to be direct and pointed in our statements, I can answer Mr. Clark's question for today quite clearly. I am comfortable with the general structure of the proposed terms of reference, with one exception, already mentioned by Mr. Donecker, which is the issue of prolonged use of ESAF and the effects of the modifications to the ESAF instrument on the effectiveness of the facility.

Second, on publicity. I acknowledge Mr. Newman's point about the need for transparency and sound public relations. But I also share the Managing Director's concern that too much publicity could interfere with the work of the evaluators by exposing them to pressures from interest groups that could impair the objectivity of their work. I tend to support the Managing Director's call to let the four evaluators do their work in conditions of calm and serenity.

Third, the price tag for the study is somewhat on the high side. The study should not be conducted at the expense of other objectives and tasks of the Fund. To avoid this during a period of budget consolidation will require appropriate reprioritization of our work program and the budget.

Fourth, concerning the issue of ESAF's social impact, I agree with the comments of those speakers who expressed concern about possible duplications of effort, especially in connection with the studies undertaken in the World Bank. But we should also be careful not to ask the question in the wrong way, as though the Fund were responsible for the problems of these countries. I was struck by the Managing Director's remarks yesterday about the corrosive and destructive effects of irresponsible populist policies on the social and economic fabric of member countries. In many cases, countries need ESAF programs because they pursued such reckless populist policies.

We should therefore not mix up cause and effect by holding "the good doctor—to use Mr. Sivaraman's metaphor—responsible for the problems of the patient.

Finally, after the extensive discussions in Mr Clark's working group, I had expected that there would be little or no discussion in today's Board meeting. Instead, Directors are asking for more clarifications and putting forward new items for the agenda of the evaluators. I am afraid that this process—including the idea of an additional seminar on the evaluation project—could lead to overloading of the study and even to study fatigue. We should trust the competence of the evaluators and let them do the work without constantly interfering and looking over their shoulders.

Mr. Al-Turki made the following statement:

I join other speakers in thanking the Evaluation Group under the Chairmanship of Mr. Clark for their efforts in bringing the report before us.

As I am in broad agreement with the thrust of the report, I will be brief.

First, it will be both interesting and useful to review developments in social indicators under ESAF supported programs. However, from the Fund's operational point of view the most relevant objective is to ascertain whether improvements in social indicators during an ESAF program are positively correlated with the sustainability and success of the adjustment effort.

Improving social conditions is a most important endeavor which I am sure we all support. The World Bank and some U. N. agencies should take the lead as they have the mandate and the expertise in this area. The Fund's greatest contribution to this effort is through programs that promote external viability and sustainable growth. Effective coordination among these institutions is clearly essential. Further discussion and consideration of this point with the external evaluators, as suggested by Mr. Clark, seem to be important.

Second, the panel of experts that is being proposed is diverse and experienced. I support their selection and look forward to their seminar.

Third, I agree with the guidelines for country selection. Here, I would emphasize the importance of selecting the same countries for the three sections of the evaluation.

Fourth, while I have no objection that the report be prepared with the assumption that it will be published by the Fund, it is essential that candidness is not comprised in the process. In that connection, could the staff inform us if such a report, which is based on confidential information, could be published without the consent of the authorities concerned.

The Chairman said that the staff would review carefully the report to ensure that confidential material was not published.

Mr. Coumbis made the following statement:

> I join other Directors in commending Mr. Clark and members of the Fund's Evaluation Group for their excellent work done in a short time. I have no problems with the Groups's proposals for an external evaluation of certain aspects of the ESAF.
>
> With respect to the terms of reference, I agree with the Chairman's comment that we should not lose time with the terms of reference, for the reasons expressed by Mr. Clark. The many good points of Mr. Sivaraman, Mrs. Farid, and other Directors could usefully be made in the seminar with the evaluators. While I share Mr. Autheman's concern regarding the utilization of the World Bank's work, especially by the Bank's Evaluation Department, I agree with Mr. Clark that the matter could be raised during the seminar as well. I agree with the Chairman that it would be premature to announce the evaluation in the press at present, or to permit outside observers to participate in the seminar.
>
> I have the same question as Mr. Newman on the relationship between the Policy Development and Review Department's review of the ESAF and the external evaluation of the Policy Development and Review Department's work. Publication of the evaluation report can be discussed once the report had been completed.

Mr. Shields said that he was gratified that the external review would be comprehensive, and that it would be going ahead quickly. He could support the terms of reference, given that the evaluators would inevitably interpret them with some flexibility

He hoped that it would be possible to have both a candid report and one that would be published, Mr. Shields stated. He had been concerned that the sentence in the paper dealing with possible publication—to the effect that the evaluators were invited to prepare their report on the assumption that it would be published by the Fund—perhaps implied that the report would need to be tuned for publication. However, as he accepted the Chairman's assurances to the contrary, he looked forward to a full and frank report that the Board could then decide to publish. It was important not to overlook the need for further evaluations, and he agreed with Mr. Clark that, by early in the following year, the Board should begin to consider the next topic for evaluation, which he hoped would be in a completely different area.

It was appropriate that the Board not discuss the evaluation again—other than at the seminar—before the submission of the report, Mr. Shields considered. He hoped that the Evaluation Group would discuss progress with the evaluators several times during the evaluation, to address any issues that might arise, particularly as the results of evaluations could sometimes differ from what had been expected.

As various organizations were aware that there would be an external evaluation, and were asking questions, the Fund should provide the press with some information about it, Mr. Shields emphasized. A formal press release should be issued, although it might be necessary to be discreet about the identity of the evaluators.

He was impressed by the quality of the evaluators, Mr. Shields observed. So as not to compromise the invaluable advice of Mr. Botchwey, the former Ghanaian Finance Minister, Ghana should perhaps be excluded from the series of case studies in the evaluation. He agreed with Mr. Newman that the Board should obtain the views of the external evaluators on the Fund's internal review of the ESAF, at least by the time the Board discussed the latter.

Mr. Waterman made the following statement:

> Like others, I welcome the report. I would like to thank Mr. Clark and his group and relevant staff for the considerable efforts they have made in progressing the work on this evaluation. I also agree with Mr. Clark that in some ways it might have been easier to have started with a less complex and sensitive subject. At the same time, it is a very important subject for us, and one on which the Policy Development and Review Department's work is already under way. So the external work should be both timely and useful.
>
> If I had a reaction in reading the papers, it was, if anything, that it seems to me there is a risk that we will make the exercise a little more complex and detailed than I would have preferred, but I do not have any basic problems with what is being proposed, with efforts to integrate the work being very important, and to draw on the work already done within the Fund and relevant work by the World Bank, as others have already commented.
>
> I certainly like the idea of appointing one of the evaluators as a convener for discussions and so on. I also like the proposed seminar with the independent experts. I would not necessarily rule out some adjustments in the terms of reference, if there has been an obvious oversight that they or someone could point to, but I think we should be looking at limiting further changes to the terms of reference at this stage.
>
> I think Mr. Clark made a good point that the experts obviously need some flexibility in the way they work. We would presume they would exercise that in any case. But it is also important that we make sure they are not duplicating, as opposed to commenting and drawing on, work already done by the Fund and others. In this regard, I like the idea of the evaluators preparing uniform conclusions, which should assist us in drawing out the potential benefits of the evaluation work and helping us integrate it with the internal work undertaken by the Policy Development and Review Department.
>
> I think Mr. Mesaki has raised an important issue as to how we bring together the internal and external work or certainly get some input from the external evaluators at the time we are considering the work being undertaken by the Policy Development and Review Department. But generally I like the idea now of proceeding with the external work as soon as possible. It is important to keep to the proposed timetable. The chairman of the evaluation group and his colleagues have an important ongoing role here.
>
> On balance, I believe a short—and I emphasize "short"—press release on this proposed work would be useful because, if asked about it, we do need to be in a position to say something.

Finally, on the question of publication, I basically agree with what Mr. Donecker had to say on this. I think it is a decision that we can take after the report is received and debated. Personally, I do not have a problem with publication of the report or something drawing on the reports, but the primary objective should be to get a high quality product that generates some ideas on how we might improve the operation of ESAF.

Mrs. van Geest said that her authorities agreed that the issue of publication of the evaluation report did not have to be decided at present. Her authorities strongly favored publication, nonetheless, as it would help to ensure parliamentary approval in the Netherlands of continued ESAF funding.

In light of the Chairman's assurances and the high quality of the evaluators, she believed that the latter's candor would not be constrained by the possibility of publication, although they should still be made aware of that possibility, Mrs. van Geest remarked. On previous occasions, in regard to other institutions, the possibility of publication of outside experts' work had not been highlighted, which, unfortunately, had meant that some worthwhile reports had not been published.

The Chairman said that Mrs. van Geest's point was well taken. In that connection the terms of reference mentioned that those whose actions and advice were the subject of the evaluation should have an opportunity to respond to, and perhaps dissent from, relevant parts of the draft and the final evaluation report. He expected that the Board would agree to publish the evaluation report.

The Director of the Office of Internal Audit and Inspection said that the evaluators would be invited to present unified conclusions, based on their three separate evaluation chapters and on the review of the ESAF to be completed by the Policy Development and Review Department by spring 1997. As he understood it, the Board would only obtain the views of the evaluators on the Policy Development and Review Department's review when the evaluators submitted their report in late 1997. He did not expect the evaluators to have done sufficient research by spring 1997 to be in a position to comment then on the Policy Development and Review Department's review of the ESAF.

Mr. Clark commented that the Fund had made much progress on evaluation over the preceding two years. The first time the Board had discussed evaluation, Directors' views had diverged sharply on the merits of and approaches to evaluation. It was not surprising that the nuanced differences of view of Directors on the purpose, design, and funding of ESAF programs had come through in the discussion on the proposed evaluation.

Directors needed to keep in mind that the external evaluation procedures were experimental, Mr. Clark emphasized, and would themselves be evaluated by the Board in two years' time. To have a successful experiment, the Fund had to proceed with the evaluation of the ESAF. The Board should thus approve the proposed evaluation, while noting that there were many remaining issues that it would wish to raise over the coming months. For example, the issues of emphasis that Mr. Donecker, Mrs. Farid, Mr. Barro Chambrier, and Mr. Guzmán-Calafell had raised on the relative weighting of the various points in the terms of reference could be communicated to the evaluators; the lead evaluator, Mr. Botchwey, would be visiting the Fund the following week, and he would have an opportunity meet with Directors and to hear their concerns first hand. The proposed seminar—the format of which could be discussed over the coming months—would provide another means of informing evaluators of Directors' views.

While he agreed with the response of the Director of the Office of Internal Audit and Inspection to Mr. Newman's question on how to obtain the evaluators' views on the Policy Development and Review Department's review of the ESAF, he would not rule out the possibility that they could provide preliminary comments before they submitted their final evaluation report, Mr. Clark considered. The question of publication of the evaluation report could be decided at a later stage.

Regarding the press release on the evaluation, Mr. Clark continued, he would recommend that the Fund use the statement developed by himself and the Director of the External Relations Department, namely:

> "An evaluation of aspects of ESAF-supported programs by independent external experts will be undertaken. The independent experts [named] will evaluate three topics [identified], and will have full access to any information in possession of the Fund. The experts are invited to prepare their report on the assumption that the evaluation report will be published by the Fund, and are expected to complete their report by late 1997."

Those remarks could be attributed to himself, if appropriate; and if Directors were questioned, they could simply use the statement, which represented a compromise between a full press release and nothing at all. The Fund should not be tempted to release the full terms of reference, however.

The Director of the Policy Development and Review Department said that the staff was considering conditionality under the ESAF, including possibly moving to quarterly performance criteria. The staff would first have to complete the review before it could arrive at conclusions on quarterly performance criteria. The issue arose, nonetheless, of what aspects of ESAF-supported programs should be tightened—whether the macro or financial aspects of the programs, which lent themselves to quarterly criteria, or the structural aspects, which often did not lend themselves to such criteria. The Policy Development and Review Department's review would consider, inter alia, overall macroeconomic performance and program interruptions.

The World Bank's review of its structural adjustment lending could differ greatly from the Fund's ESAF review, the Director noted. The Bank, in fact, had not yet decided how it would review such lending; it was currently discussing the methodology for the review, to be comprised of studies by nongovernmental organizations in coordination with the Bank. The Fund would contribute to the Bank's review, but not as a partner.

It was important for the Policy Development and Review Department staff reviewing the ESAF to keep in close contact with the external evaluators, the Director considered. The staff would meet with Mr. Botchwey when he visited Washington on November 11, to brief him on its plans for the internal ESAF review, and it would later obtain his and the other evaluators' views on the Policy Development and Review Department's review. He hoped therefore that the Policy Development and Review Department's review and the external evaluation of the ESAF would be complementary.

Mr. Newman remarked that his earlier comment had meant to suggest that the Fund should seek to avoid the perception that its process of review was less open and transparent than the Bank's. At a time when both institutions were seeking additional resources from their members, the one that was more open and transparent would likely be regarded more favorably than the one that was not. It was not clear whether the statement mentioned by Mr. Clark should be attributed to himself, the Managing Director, or to the Fund. It would be useful for Directors to receive a copy of the statement, to help them to answer inquiries as well.

The Chairman said that, given that Mr. Clark's term as Executive Director was ending, the press release—in Mr. Clark's words—should probably be attributed to the External Relations Department. He suggested that the text be modified to note that the external evaluators would be "invited to conduct all consultations they judged appropriate," and that the text indicating that they would be invited to prepare their report on the assumption that it would be published should be deleted, as it would imply that their candor might be constrained. The press release should probably also mention that the evaluators were expected to complete their report before end-1997.

He strongly favored the idea of the Board's having some preliminary report by the evaluators on the basic thrust of their work, so that Directors could take advantage of the conclusions at an early stage, the Chairman remarked. In any event, the proposed seminar would provide a good opportunity to clarify the direction in which evaluators were going, and to provide them with the Board's views.

Mr. Clark indicated that he agreed with the Chairman's suggestions.

The Executive Board took the following decision:

> The Executive Board approves the terms of reference dated October 16, 1996 for the external evaluation of the Enhanced Structural Adjustment Facility, as described in EBAP/96/103, and as amended at EBM/96/98 (10/30/96).

Decision No. 11370-(96/98), adopted
October 30, 1996

4. EXECUTIVE DIRECTORS

The Chairman bade farewell to Mr. Clark, Mr. Ismael, Mr. Koissy, and Mr. Saito upon the completion of their service as Executive Directors, and to Mrs. Cheong upon the completion of her service as Alternate Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/97 (10/5/96) and EBM/96/98 (10/30/96).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/96/178 (10/25/96), by an Advisor to Executive Director as set forth in EBAM/96/177 (10/24/96), and by an Assistant to Executive Director as set forth in EBAM/96/176 (10/24/96) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/96/108 (10/25/96) is approved.

APPROVAL: July 31, 1997

REINHARD H. MUNZBERG
Secretary