June 20, 1997
Approval: 6/27/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/105

10:00 a.m., November 25, 1996

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

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

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
	M.F. Melhem, Temporary
	O.A. Himani, Temporary
M.-A. Autheman	A. Fayolle
	L. Fontaine, Temporary
	H. Paris, Temporary
T.A. Bernes	C.X. O'Loghlin
	T. Turner Huggins, Temporary
	C.K. Duenwald, Temporary
B. Esdar	W.-D. Donecker
	O. Schmalzriedt, Temporary
H. Evans	J. Shields
E.R. Grilli	N. Coumbis
	J.C. Martinez Oliva, Temporary
	J.N. Santos, Temporary
	G. Schlitzer, Temporary
D.Z. Guti	J.M. Jones, Temporary
	W.K. Gruber, Temporary
	O. Issaev, Temporary
A. Kafka	J. John, Temporary
W. Kiekens	A. Cserés, Temporary
	M. Nemli, Temporary
	B.S. Newman
	M. Sobel, Temporary
H. Mesaki	H. Ono
	H. Ogushi, Temporary
	M.-H. Mahdavian, Temporary
	A. Vernikov
	B.M. Lvin, Temporary
	V.Y. Verjbitski, Temporary
A.S. Shaalan	Y.Y. Mohammed
M.R. Sivaraman	H.B. Disanayaka
	R.P. Watal, Temporary
E. Srejber	B. Andersen
	T. Brizuela, Temporary
	J.L. Pascual, Temporary
E.L. Waterman	A.G. Yakub, Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
	G.A. Kyriacou, Temporary
K. Yao	A. Barro Chambrier
	S. Joyosumarto
Zhang Z.	Han M.
	Zheng H., Temporary
A.G. Zoccali	J. Leiva
	J.A. Costa, Temporary

R.H. Munzberg, Associate Secretary
W.S. Tseng, Acting Secretary
P. Cirillo, Assistant

Also Present

IBRD: M. Farsad, Europe and Central Asia Regional Office; F. Nsengiyumva, Western Africa Regional Office; A.L. Winters, International Economics Department. African Department: E.A. Calamitsis, Director; G.E. Gondwe, Deputy Director; K.J. Cady, M. F. Desclercs, J.E.J. De Vrijer, I.A.H. Diogo, E. Harris, N. Kirmani, M.W. Lewis, P.D. Peroz, P. Rother. Central Asia Department: H. Neiss, Director. European I Department: M. Russo, Director. European II Department: J. Odling-Smee, Director; A.V. Arvanitis, J. Berengaut, O.P. Brekk, D.J. Donovan, P. Garibaldi, J. Márquez-Ruarte, L.E. Psalida, A.J. Richards, R.E. Stern, E. van der Mensbrugghe, K.A. Westin. External Relations Department: S.J. Anjaria, Director; H.P. Puentes. Legal Department: F.P. Gianviti, General Counsel; W.E. Holder, Deputy General Counsel; R.C. Baban, H. Cisse, P. De Boeck, D.E. Siegel. Middle Eastern Department: P. Chabrier, Director. Policy Development and Review Department: J.T. Boorman, Director; J. Ferran, Deputy Director; O. Havrylyshyn, Deputy Director; G.C. Anayiotos, G.A. Barnard, N. Calika, S.M. Schadler, R.L. Sharer, C.R. Shiells, N. Tsaveas. Secretary's Department: L. Van Houtven, Secretary and Counsellor; S. Bhatia, J.M. Boughton, D.J. De Vos, R.S. Franklin, K.S. Friedman, J.J. Polak, S.W. Tenney, G.N. Walton. South East Asia and Pacific Department: A. Singh, Deputy Director; G.N. Bascand, R.M. Brooks, C.M. Browne, J.H. Felman, A.A.F. Op de Beke, M. Sarel, M.R. Stone. Statistics Department: J.B. McLenaghan, Director. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; G. Wittich, Deputy Treasurer; J.C. Coor, C.A. Hatch, Y.-F. Lum. Western Hemisphere Department: F. van Beek, G. Yadav. Office of the Managing Director: S. Sugisaki, Special Advisor; J.A.P. Clément. Advisors to Executive Directors: M.A. Ahmed, P.A. Akatu, M.B. Alemán, S.S. Farid, P.M. Fremann, T.K. Gaspard, C.M. Gonzalez, He J., G.M. Iradian, J. Jonáš, R. Kannan, H. Mori, J.-C. Obame, O. Otazú. Assistants to Executive Directors: J.G. Borpujari, M. A. Brettschneider, M.A. Brooke, K. Brownlee, M.A. Cilento, H.W. Cocker, D.A.A. Daco, J.C. Estrella, S. Fukushima, D. Giga, B. Grikinytė, D.S. Hakura, J. Hamilius, Huang X., P.M. Hung, H. Javaheri, H. Kaufmann, E. Kouprianova, K. Kpetigo, J.P. Leijdekker, D.G. Loevinger, J. Mafararikwa, I. Moon, J.A.K. Munthali, S. Rouai, D. Saha, S. Simonsen, Y. Tahara, E.L. Zamalloa.

1. REPORT BY DEPUTY MANAGING DIRECTOR

At Informal Session 96/10 (11/20/96), the Deputy Managing Director, Mr. Ouattara, reported briefly on his recent travel to Brescia, Italy to attend a symposium, organized by the Giuseppe Tovini Foundation, on the international voluntary partnership between Europe and Africa.

The Deputy Managing Director made the following statement:

> I attended a symposium in Brescia, Italy, on The International Voluntary Partnership between Europe and Africa, organized by the Giuseppe Tovini Foundation, on Saturday, November 16, 1996. The Giuseppe Tovini Foundation was created in 1957 to contribute to the training and specialization of teachers, educators, group leaders, and social workers. More than a thousand participants included representatives of NGOs, academics, young volunteers, and representatives of the catholic church, including a number of cardinals and officials from the Vatican government. The symposium was chaired by Cardinal Paul Poupard, the former head of the Catholic Diocese of Paris, currently in charge of the cultural affairs in the Vatican.
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> In my keynote speech, I emphasized the remarkable progress that Africa has made in the last few years and described the elements of a new partnership for development in Africa. As you know, Pope John Paul II in his apostolic exhortation, *Ecclesia in Africa*, focuses on the need for good governance, participatory development, equitable growth. The Pope calls for the Fund and the World Bank to "alleviate the crushing debts of the African nations."
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> The audience was very appreciative to have this opportunity to exchange views with the Fund management. The discussions were very cordial and covered a wide range of issues (ethnic conflicts in Africa, governance, official aid and voluntary support, income inequality, etc.). The young volunteers and the Catholic church representatives were particularly comforted to see that Africa was moving forward and that indicators, which were new to them, showed clearly that many countries were doing better. I felt that this dialogue gave them a renewed enthusiasm and hope in their challenging and important tasks. They realized that the Fund was not after all the devil and they appreciated particularly the Fund's contribution to better policies in Africa. I then met with the local and national press.
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> Overall, I think that this symposium was a real opportunity to fill the information gap on what is going on at the macro level in Africa with the help of the Bretton Woods institutions. I was pleased at the end of the symposium to feel a sort of relief among participants who said that they discovered that Africa was on the move toward a better future and, therefore, that their own very important efforts were not in vain despite present tragedies in the region of the Great Lakes.

2. MALI—1996 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY—REVIEW UNDER FIRST ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1996 Article IV consultation with Mali and the midterm review under the first annual arrangement for Mali under the Enhanced Structural Adjustment Facility (ESAF) (EBS/96/169, 11/5/96). They also had before them a background paper on selected issues in Mali and a statistical annex (SM/96/279, 11/7/96).

Mr. Yao made the following statement:

> My Malian authorities are in broad agreement with staff's analysis of recent developments and immediate prospects of their economy, following the fruitful discussions held in Bamako and more recently in Washington at the time of the Annual Meetings.
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> As described in the staff report, the Malian economy has continued to respond favorably to various policy and structural measures implemented by the government within the framework of the adjustment program supported by arrangements under the ESAF. Real GDP grew by 6.4 percent in 1995 as against 2.3 percent in 1994. At the same time, inflation fell sharply from 32 percent in 1994 to about 9 percent in 1995. The external current account (excluding official grants) narrowed by 3 percentage points of GDP during the same period. The main factors behind this good performance include strong fiscal consolidation efforts and tight monetary policy. Progress was also achieved on structural reforms, namely in the promotion of private sector activities and the restructuring of the public enterprise and the financial sectors.
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> Economic trends during the first six months of 1996 are broadly in line with program expectations. All the benchmarks for end-March and performance criteria for end-June have been observed. On the basis of some production indicators, real GDP is expected to increase by 4 percent, owing mainly to higher agricultural output in the cotton subsector. Price movements suggest that inflation will be somewhat higher than targeted, due to recent increases in the prices of cereals and seasonal supply shortages ahead of the new harvest. However, in the external sector, favorable international prices for Mali's main exports, cotton and gold, associated with the moderate growth of imports, and the positive impact of a recent debt rescheduling agreement with Paris Club creditors under the Naples terms, should help to achieve the external current account deficit objective and improve the net foreign assets position of the banking system.
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> My authorities are confident that the 1996 program objectives, although ambitious, are attainable, because of their determination to implement the policy measures envisaged and their readiness to take corrective measures, should it become necessary to keep the program on track. In this context, they are pursuing their adjustment program with a view to achieving further fiscal consolidation, promoting private sector development and reforming public enterprises.

In the fiscal sector, substantial progress is being made to reduce the overall government deficit, which is now expected to be lower than programmed. At end-June 1996, owing to a strong revenue mobilization effort and strict control over expenditures, including the wage bill, the fiscal deficit (on a commitment basis and excluding grants) was equivalent to 1.0 percent of GDP as against 3.7 percent of GDP in the program. For the remainder of the year, there are indications that revenue performance, boosted by the improvement in the operations of customs and tax administrations, will remain strong and will more than compensate for the slightly higher level of expenditure that is now projected. This increase in expenditure will result mainly from higher outlays on public enterprise restructuring and clearance of outstanding liabilities. However, expenditure on other items, including the wage bill, will remain as targeted. Altogether, these factors should contribute to reduce the overall fiscal deficit to about 9 percent of GDP, somewhat lower than initially projected.

Regarding monetary policy, its implementation, in the context of the existing regional monetary arrangement, will continue to be prudent and consistent with the inflation and the balance of payments objectives. To this end, credit to the government will remain restrictive, while the credit needs of the private sector will be accommodated. In their efforts to rely on the use of indirect instruments in the conduct of monetary policy, my authorities are strengthening the role of existing market mechanisms, namely the open-market operations. They are also taking steps to improve the effectiveness of financial intermediation by increasing inspection and enforcing the prudential ratios set by the regional banking commission. The authorities are also supporting the restructuring of two major financial institutions, the Banque internationale du Mali - S.A. and the Société des chèques postaux et de la Caisse d'épargne. Moreover, it is the authorities' intention to conduct with assistance from the World Bank before end 1996 an evaluation of the financial institutions in Mali, in order to prepare a strategy for the strengthening of the banking system.

In the external sector, preliminary data indicate that the continued expansion of exports (cotton, gold, livestock) and the moderate growth of imports, should facilitate the achievement of the balance of payments objective. The external current account deficit, excluding official transfers, is therefore expected to be reduced to the equivalent of about 13 percent of GDP in 1996 as against about 15 percent registered in 1995.

On structural reforms, efforts are being directed at promoting private sector development and reducing gradually government interventions in economic activities. To this end, regulatory framework including the functioning of administrative Tribunals and Commercial Courts is being improved. In the same vein, training of commercial bank staff in investment analysis and monitoring is also being encouraged. In order to increase the competitiveness of local production, a coherent and transparent rice import tax system has been designed. Moreover, a Round Table is scheduled to be held in Bamako toward the end of this month in order to encourage private investment in Mali.

The reform of public enterprises will continue to be a top priority in my authorities' agenda. To that effect, economic and financial information on most public enterprises is being updated. Meanwhile, for those public enterprises remaining in the government's portfolio, such as the power company (E.M.) or the Société des Telecommunications du Mali (SOTELMA), a close monitoring is being exerted so as to strengthen their management and financial situation.

In conclusion, there is no doubt that Mali has made substantial progress over the past few years in its adjustment and reform efforts. However my authorities are cognizant that the country's economic and financial situation remains fragile and that continued efforts will be required to ensure that economy stays on the path of sustainable growth. In this context, it is their expectation that with both their strong determination to the adjustment process and timely external financial assistance, they can achieve the objectives set in their program. They are very grateful for the support they have so far received from the international community and look forward to continued assistance from the Bretton Woods institutions.

Mr. Newman, speaking on behalf of Ms. Lissakers, made the following statement:

Many of the remarks I made earlier this week on Uganda could equally be applied to Mali, for it is another example of how the right policy mix and strong support from the international community, including debt reduction, can produce impressive results. When designing programs elsewhere in Africa, both Uganda and Mali serve as important reminders of what can be achieved when the Fund insists on rigorous policies and the authorities themselves act with determination. With elections next year, the authorities will undoubtedly come under pressure to loosen financial policies and delay key structural reforms. We urge the authorities to resist these pressures.

However, despite its impressive track record, after eight years of Fund arrangements, per capita GDP remains low, and Mali remains dependent on concessional financing and is vulnerable to changes in commodity prices and the weather. It is important that in the remaining years of this ESAF the authorities take additional measures to reduce macroeconomic imbalances and structural impediments to growth. These include: increasing revenues, which at less than 15 percent of GDP, leave the authorities too dependent on official external financing; liberalizing trade and reducing the reliance on trade taxes, which account for almost half of budgetary revenues. In particular, we agree with staff that the authorities should eliminate the export tax on raw goat and sheep skins, which also runs counter to the authorities' goal of deepening regional integration. It is disappointing that after eight years of structural reform programs under ESAF, Mali remains a highly protected economy with a maximum tariff rate of 36 percent and an average effective tariff of 19 percent; reducing state ownership of firms in commercial sectors; and securing debt relief from non–Paris Club bilateral creditors, who we urge to be forthcoming.

Finally, given its strong performance, and the fact that the program was reviewed seven months ago, and will be reviewed again early next year, Mali would have been an ideal candidate for our new lapse of time procedures.

Unfortunately, my staff had been focusing on Uganda, as I am sure was the case for many other offices, and did not have a chance to read the staff report until after the deadline for initiating these procedure had expired. As a practical matter, I think we are going to have to rely in many cases on management and the Executive Director of the country concerned to identify cases that could be considered on a lapse of time basis.

Mr. Shaalan asked whether the staff report for the 1996 Article IV consultation and the midterm review under the first annual arrangement under the ESAF could be considered on a lapse of time basis.

The Acting Secretary recalled that the Board recently had agreed on procedures for the use of lapse of time consideration of Article IV consultation reports, that is, proposals for lapse of time consideration should be submitted no later than four business days of the scheduled Board meeting, and the deadline for a proposal for lapse of time consideration of the Mali item had passed on the close of business on November 18, 1996. As Mr. Shaalan's request did not meet the deadline specified in the agreed procedure, it was up to the Board to decide whether the procedure should be changed to accommodate the request. The Acting Secretary recalled that there had been significant support at the recent Board meeting on the lapse of time procedure on the importance of holding annual Board discussions on Article IV staff reports; also, the Managing Director had stated that it was important for the views of the Board to be expressed formally in the summing up of such Board discussions.

The Acting Chairman noted that, while it would have been easier to use the lapse of time procedure for program reviews, in the case of Article IV consultation discussions, especially for smaller countries, Board discussion was important.

The Acting Secretary stated that the staff was preparing a paper, to be circulated to the Board shortly, on the use of lapse of time procedures for program reviews; also, Directors had agreed to discuss shortly procedures to improve the efficiency of Board discussions, particularly in light of the increasing Board workload.

Ms. Turner-Huggins made the following statement:

I wish to thank the staff for an interesting and useful set of papers (the RED was particularly helpful) and to commend the Malian authorities for reaching this mid term review having over performed in most of the quantitative benchmarks. Mali stands amid the exemplary reformers in francophone Africa and appears to be benefiting from the 1994 exchange rate devaluation in a substantive way. We are told that cotton and cereal farmers have increased their net income since devaluation between 14 and 24 percent. This is significant in a country where the bulk of the population is rural and GDP per capita is among the lowest in the world.

On fiscal policy: two areas stand out: first, tax revenue—we urge the authorities to keep up efforts to improve the tax to GDP ratio, and join the staff in noting this a major concern and would encourage the early adoption of measures to broaden the tax base by reviewing taxes on petroleum productions and rationalizing tax exemptions on imports; second; the government of Mali has been able to restrain growth in civil servants salaries over the last few years, however we recognize that temptations will mount as the elections loom. We would like to emphasize that Mali cannot afford to jeopardize any further deterioration in its external competitiveness (note the 12 percent appreciation of the real effective exchange rate in 1995 and the continued trend so far this year) and we urge the authorities to help keep wage pressures to a minimum to avoid contagion to the private sector.

Regarding trends in the banking system, the data on nonperforming loans and the large interest rate spreads are troubling. Perhaps staff can elaborate a little on the reason behind the large spread given its recommendation to the authorities to increase provisioning to cover nonperforming loans. In the meantime, we look forward to the World Bank's report and recommendations for financial sector reform and would urge the authorities to maintain adequate prudential and supervisory guidelines in monitoring the banking system.

We note that military spending has been growing in nominal value since 1993, although we do not have any data for 1995. Can the staff or Mr. Yao provide us the status of these expenditures—in light of the delayed implementation of social safety net projects in northern Mali this year? Is there any relationship between these budget items?

On enterprise reforms, Mali still has a very complex public enterprise system with considerable government ownership throughout the economy. The privatization efforts are very encouraging, and as noted in Mr. Yao's statement—reform of the enterprise sector will continue to be top priority—and the improved financial operations of the public enterprise sector is laudable. We wish to add our voice to maintaining strong efforts in the divestment and restructuring areas, and look forward to the results of the audit of the public enterprise sector soon to be completed by the World Bank.

Finally, let me commend the Malian authorities for their determined efforts and urge them to continue steadfastly in their adjustment strategies under the ESAF, and to wish them every success in meeting their goals.

Mr. Santos made the following statement:

Despite a good performance under the ESAF program, the economic situation in Mali is still fragile. Domestic and external imbalances are still high (in 1996, the overall fiscal deficit excluding grants and the external current account balance excluding official transfers are estimated at 9.1 and 13.2 percent of GDP, respectively), and not significantly different from what they were just before the devaluation of the CFA franc in early 1994.

consumer price index inflation has also yet to reach the predevaluation levels, contrary to the experience of other CFA countries. Reducing inflation to the level of partner countries is not only a program goal but is also particularly important to prevent further loss of the competitiveness that the economy gained with the devaluation of the CFA franc. In 1996, the decline in inflation observed during the first seven months (to about 7 percent at end-July, on an annual basis), falls short of the programmed pace of decline in inflation for the whole year, mostly reflecting larger-than-expected increases in the prices of rice and other cereals. We understand that steps have already been taken, namely a reduction of customs duty on imported rice, which should contribute to increasing supply and lowering retail prices . However, any reduction in price pressures in the cereals markets should be based on increased competition in the marketing of cereals by facilitating access of operators into import and marketing activities through reduced licensing fees.

On the fiscal side, we welcome the very good performance both on the revenue and expenditure side, with program targets being met by comfortable margins. However, tax revenues are still very low in GDP terms, and further efforts need to be made to broaden the revenue base and to rationalize exemptions from import duties.

On the monetary sector, we learned that the high spread between deposit and lending interest rates is due to the significant level of nonperforming loans in bank's portfolios. However, we wonder whether the loan rate reflects only the quality of the new loans rather than the quality of the overall portfolio. Otherwise, how can commercial banks with a higher percentage of nonperforming loans compete with those that have a relatively better quality portfolio? On the other side, if the high loan interest rate reflects a high risk premium of the new loans, then we question the wisdom of such an aggressive strategy of the commercial banks. In any case, such high interest rate spread must reflect a less than effective financial intermediation. Hence, we urge the authorities to give renewed attention to the recovery of bad loans, even because sole emphasis in increased provisioning would contribute to tighten considerably the terms of lending or even restrict lending, thus reducing the bank's support to economic activity.

We note that progress achieved in structural adjustment is broadly satisfactory. However, deregulation, opening up, and modernization of the economy should contribute to make it more efficient. We note that the marginal productivity of capital is still quite low, as the high investment ratios (around 26 percent of GDP, in 1994–96) contrast with annual growth rates of the GDP of just about 4 percent for the same period. Finally, we welcome the improvement of the financial position of the public enterprise sector, in large part a reflection of the devaluation of the CFA franc, and urge the authorities to press ahead with the reform program to privatize or liquidate those enterprises in areas where the government has no compelling reason to be involved, and to strengthen those enterprises remaining in the public sector.

Mr. Gruber made the following statement:

We join previous speakers in commending the Malian authorities for the success in implementing the adjustment program which has been in many respects impressing. This is the case for the continuing macroeconomic and fiscal stabilization policy, which is reflected in falling inflation, increasing domestic savings and investments, and a further reduction of fiscal imbalances. We would like to urge the authorities to continue on this road and, in particular, to resist any pressures to loosen fiscal policy before the elections next year.

However, if the success of this stabilization policy is obvious, the effects of the structural reforms (after eight years of Fund arrangements) are more ambiguous. Structural reforms seem to have lost some momentum in 1996. The growth rate remains relatively modest, the economy is still very vulnerable to changes in prices of a few commodities and the dependence on concessional financing of the international community remains high. We would like to emphasize, therefore, the importance of strengthening the efforts in trade liberalization, private sector promotion and public enterprise privatization to enhance and broaden the basis for sustained economic growth.

Finally, we would like to call to mind the third key area of the authorities' medium-term adjustment strategy for 1996–98 which is to undertake well-targeted actions to make significant inroads against poverty. Unfortunately, the staff report does not provide much information neither about concrete measures undertaken nor about data available on the effects of the experienced growth on the well-being of Mali's population. We think, we should pay more attention to this aspect and would be grateful, if the next staff report could give more information about this.

With these remarks we support the completion of the review and wish the authorities success in their future endeavor.

Mr. Mahdavian made the following statement:

The performance of the Malian economy over the first half of 1996 has been encouraging. The combination of sound macroeconomic policies and structural reform since 1994 has resulted in economic growth of 6.5 percent in 1995, while inflation was reduced sharply to 9 percent over the same period. The external current account deficit and overall fiscal deficit, excluding grants, were notably reduced in 1995. These achievements combined with strengthened competitiveness of the economy are reflections of the positive, albeit very difficult, path that Mali has followed over several years to bring about very substantial improvement in macroeconomic conditions. Despite these developments however, the balance of payments position remains vulnerable to external shocks and highly dependent on exceptional foreign financing.

Attempts to reduce overall government budget deficit, excluding grants, has been strengthened considerably over the recent years and it now appears that the deficit will be kept around 10 percent of GDP over the current year. Latest information indicates that the revenue performance for end June 1996 exceeded the program target by a large margin and expenditures were lower than the program level. For the remainder of the year, the authorities need to improve tax administration and collection and reduce exemptions, since the room for adjustment on the expenditure side appears limited. In addition to improvement in tax administration and collection, the authorities may need to identify and implement additional revenue measures toward the required reduction in budget deficit, while maintaining capital and social outlays and meeting the additional burden of election costs. Staff has usefully indicated certain measures of revenue enhancement and expenditure containment for further strengthening of government fiscal position. It would be prudent for the authorities to adopt these policies in current year and incorporate them in next year's budget.

The structural reforms envisaged in the program address complex and very important areas of public enterprise restructuring, private sector development, and banking sector reform. The proposed measures are crucial complements to sound fiscal and monetary policies in allowing for strengthened private sector confidence to translate into increased sustainable economic activity.

Though current account deficit has been reduced steadily over the past two years and is expected to decline to less than 9 percent of GDP at the turn of the century, the authorities need to keep a careful eye on the sustainability of the external current account deficit. I concur with Mr. Yao in his helpful statement that despite positive developments, Mali's financial situation remains fragile and the authorities' continued efforts need to be complemented by adequate external financial support.

With these remarks I support the proposed decisions.

Mr. Nemli made the following statement:

It is encouraging that Mali is continuing to build on its impressive performance in recent years with macroeconomic stabilization and structural change. It is expected that all of the macroeconomic objectives for 1996 will be achieved. The fiscal performance during the first half of the year exceeded its targets, and the authorities' determination is reflected in their decision to take advantage of this success by strengthening the ESAF-supported program's performance criteria for the second half of the year.

Though the speed of the improvement in Mali's macroeconomic conditions and the changes in the basic structure of the economy is encouraging, Mali still faces serious challenges. Mali's economic and financial situation remains fragile, and it will require many years of strenuous effort to overcome the widespread poverty. Mali is still dependent on external assistance to finance both its fiscal and external deficits. Excluding grants, the fiscal deficit is expected to reach 9.1 of GDP, and the current account deficit 13.2 percent of GDP, in 1996. These very high deficit ratios call for determined implementation of prudent macroeconomic policies and structural reforms for an extended period of time.

The authorities should concentrate their immediate effort on improving Mali's fiscal performance. The low ratio of tax revenues to GDP, estimated at 11.7 percent for 1996, points to tax collection as an area deserving the authorities' attention. I also agree with the staff that the tax base should be broadened to correct overreliance on revenues from the cotton marketing agency. On the expenditure side, the upcoming elections will test the authorities' ability to maintain their prudent policy stance. They must stand firm in order to minimize election pressures to increase spending, and take care to offset any increase in spending with measures increasing revenues. I fully endorse the authorities plan to contain nonessential spending while increasing social expenditures for education and health.

Mali should continue to build on its structural reforms. Of the key reform areas identified in the staff report, I would like to stress the importance of strengthening the judicial system. An effective judiciary is a crucial ingredient of the private sector's confidence in the economy, and in the longer run has strong and far-reaching benefits for the well-being of the entire society.

I support the proposed decision, and wish the authorities every success.

Mr. Himani made the following statement:

I welcome the important progress achieved by Mali under the ESAF. Significant strides have been made in reducing financial imbalances and an impressive array of reforms has been implemented. Indeed, the program objectives for 1996 are now largely within reach. I am in broad agreement with the staff appraisal, and will make only two brief remarks:

Recent fiscal performance is commendable. However, there are several risks on the horizon, related, in particular, to increased demands for expenditures next year. Like the staff, I would emphasize the importance of ensuring the same degree of fiscal adjustment as originally envisaged. This might necessitate the formulation of contingency measures, and I would encourage the authorities to review all possible options at an early date.

I welcome the authorities' active promotion of greater regional economic integration in the context of WAEMU. In this connection the recent imposition of export levies is unfortunate. The promotion of higher value added exports can be pursued without resort to measures that are difficult to implement and distortionary.

With these remarks, I support the proposed decision and wish the authorities continued success.

Mr. Fontaine said that he commended the authorities for their strong policy performance; he endorsed the staff appraisal, particularly the emphasis on the need to avoid substantial wage increases in 1997.

The staff representative from the African Department remarked that the large spread between deposit and lending interest rates of commercial banks was a reflection of the banks' cautiousness caused by earlier significant losses from bad loans. Given that lending rates had been freely determined in Mali since September 30, 1993, it was difficult for the authorities to interfere with the banks' assessment of the risks associated with particular lending requests.

Military spending had increased from CFAF 16 billion in 1993 to CFAF 25 billion in 1995; however, with the recent progress on the resolution of the military situation in northern Mali, military expenditure was expected to decrease, the staff representative remarked.

The government of Mali had expressed its commitment to strengthen the judicial system by, inter alia, ensuring that the commercial tribunals would be staffed by representatives of all the branches of economic activity so that an objective assessment of all cases would prevail, the staff representative stated.

Mr. Yao remarked that the relatively low tax/GDP ratio was due to the significant portion of economic activity that was in the informal sector, and hence difficult to tax. One reason that trade taxes were high was that it was relatively easy administratively to tax the trade sector. Nevertheless, the authorities would aim to raise the tax/GDP ratio wherever possible.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They commended the authorities for their determined efforts in implementing Mali's program supported by the first annual arrangement under the Enhanced Structural Adjustment Facility (ESAF), and they observed that developments thus far had been encouraging, that all the performance criteria and benchmarks through end-June 1996 had been observed, and that the macroeconomic objectives for 1996 were likely to be achieved.

Directors observed, however, that poverty reduction remained a major issue, and Mali's economy remained dependent on concessional financing and vulnerable to external shocks. Directors, therefore, emphasized that it was important for the authorities to persevere with their adjustment efforts, and to implement policies needed to consolidate the gains achieved in recent years and to further reduce macroeconomic imbalances. Moreover, with the upcoming elections in 1997, Directors urged the authorities to resist pressures to loosen financial policies or delay structural reforms.

In the fiscal area, noting the relatively low revenue-to-GDP ratio, Directors encouraged the authorities to continue their efforts to expand the tax base in order to reduce reliance on trade taxes and revenue from the cotton sector, while also improving the efficiency of tax administration and collection and eliminating tax exemptions. On the spending side, Directors encouraged the authorities to maintain their restrained stance and to avoid wage increases in excess of productivity gains; the authorities should ensure that expenditures related to the upcoming elections do not weaken the macroeconomic framework agreed for 1996–98. Directors also noted that the authorities should accelerate the execution of projects in the health and education sectors designed to alleviate poverty.

Directors expressed concern about the still weak situation of the banking system—in particular the significant level of nonperforming loans—and stressed the need for renewed attention to loan recovery and the adherence to all prudential ratios set by the regional banking commission. They welcomed the forthcoming evaluation of the financial sector to be carried out with World Bank assistance that should also identify measures to strengthen financial intermediation. Efforts to expand the role of the money market, accelerate economic integration, and intensify the coordination of the fiscal and monetary policies within the West African Economic and Monetary Union were also seen as essential.

Directors noted the commendable results achieved so far in the implementation of structural reforms and liberalization of the economy. Continued progress in the promotion of private sector development, public enterprise restructuring, reforms in the agricultural sector, and trade liberalization was considered critically important for improving prospects for sustainable economic growth. Directors urged the authorities to reduce state ownership in commercial sectors. Special attention should be given to the need to strengthen further the judicial system, complete the public enterprise divestiture program, and strengthen the management of enterprises remaining in the government's portfolio.

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

The Executive Board took the following decision:

1. Mali has consulted with the Fund in accordance with paragraph 2(d) of the first annual arrangement under the Enhanced Structural Adjustment Facility (ESAF) for Mali (EBS/96/49, Sup. 1, 4/15/96), and paragraph 5 of the letter of the Minister of Finance and Commerce of Mali dated February 18, 1996.

2. The letter of the Minister of Finance and Commerce of Mali dated September 3, 1996 shall be attached to the first annual ESAF arrangement for Mali, and the letter with annexed memorandum of February 18, 1996 shall be read as supplemented by the letter dated September 3, 1996.

3. The Fund determines that the review contemplated in paragraph 2(d) of the first annual ESAF arrangement for Mali has been completed, and that Mali may request disbursement of the second loan under that arrangement. (EBS/96/169, 11/5/96)

Decision No. 11379-(96/105), adopted
November 25, 1996

3. REPUBLIC OF LATVIA—1996 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT—REVIEW, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered the staff report for the 1996 Article IV consultation with the Republic of Latvia and the first review under the 15-month Stand-By Arrangement for the Republic of Latvia approved on May 24, 1996 (EBS/96/168, 11/4/96; and Sup. 1, 11/15/96). They also had before them a background paper on recent economic developments in the Republic of Latvia (SM/96/287, 11/13/96).

Mr. Andersen made the following statement:

> Fortunately, last year's pause in economic reforms and setback in the economic recovery, against the backdrop of a severe banking crisis and budgetary problems, turned out to be a short-lived interlude, and the implementation of the economic program, supported by a precautionary Stand-By Arrangement approved in May this year, has proceeded broadly as anticipated. All performance criteria for end-June 1996 were met, and so were all quantitative performance criteria for end-September 1996. However, my authorities regret that, due to technical reasons, the implementation of a comprehensive system of tax identification numbers has been slightly behind schedule, which has made it necessary to request that the Fund waive the applicability of the end-September structural performance criterion related to this issue.
>
> The macroeconomic achievements have been considerable: output is again growing, inflation and interest rates are markedly down, the fiscal balance has improved strongly, the exchange rate has been stable and gross international reserves have risen. In view of the relatively strong external position, my authorities maintain their intention not to make any purchase under the Stand-By Arrangement.
>
> The favorable macroeconomic developments this year owe much to the continued pursuit of firm stabilization policies, combined with decisive measures to strengthen the banking system and an accelerated structural reform agenda. In a letter to the Managing Director, the objectives of the economic program are reiterated, together with information on 1997 and the strategy for achieving them. The policies are analyzed in the excellent staff papers, as are the recent developments in the Latvian economy. My authorities are in broad agreement with the staff's analysis and appraisal. Accordingly, I will only briefly comment on a few areas of special importance.
>
> With a quick recovery of the Latvian economy, the main challenge is to lock in the gains already made, and to ensure the progress being carried forward and expanded through substantial and sustainable growth which will hold Latvia on a steadfast course toward its objective of being among the first new members of the European Union at the time of the next enlargement.
>
> Fiscal consolidation has been the primary task of the government which took office shortly before Christmas last year, and the general government

financial and fiscal targets for 1996, which involve a significant tightening, are clearly within reach. The staff has expressed concern about delays in the revenue administration measures planned under the program, including the introduction of the comprehensive taxpayer identification system referred to above. My authorities fully recognize the need to strengthen their efforts regarding tax administration and are stepping up their efforts and, as stated in the Letter of Intent, a number of initiatives are being taken with that in mind. Concerning the issuance of tax identification numbers, my authorities have deliberately chosen an ambitious target and were fully determined to achieve it on time. However, due to the need for close scrutiny of every entry into the data base, the process turned out to require more resources than foreseen. My authorities have reiterated their commitment to accomplish this task by the end of the year, and the issuance of tax identification numbers has indeed picked up strongly recently; some 48,000 enterprises had been issued tax identification numbers by mid-November compared to about 35,000 by end-September. At the same time, it is noteworthy that total government revenue has been running above program projections despite the delay in the implementation of some tax administration measures. A further fiscal tightening is planned for 1997, with the submission of a central government balanced budget in Parliament, where the first reading in October showed strong support for a balanced budget for 1997. The budget is based on rather cautious revenue projections and, on the expenditure side, a doubling of investment expenditures, with focus on infrastructure projects, deserves emphasis.

Another area where very significant efforts have been undertaken concerns the banking sector which experienced a severe crisis in 1995. Many important lessons were learned, and Latvia came out of the crisis with a smaller but stronger banking system. An extensive program of reforms and strengthened prudential and other regulations have been implemented. Key ingredients have been a new law on Credit Institutions, more frequent on-site examination by the Bank of Latvia, implementation of international accounting standards and international audits, and suspension of licenses of banks which do not comply with the strengthened regulations. As a result, the consolidation and strengthening of the banking sector are continuing as noted by the staff. Many banks have not only survived but also made profits and strengthened their capital base. The measures taken have undoubtedly been of key importance in that respect, but my authorities would also like to emphasize that the Latvian banks have been very cooperative and often have undertaken the necessary internal reforms themselves. In many cases, the banks tightened their internal control procedures and improved the risk management without prompting from the Bank of Latvia. Nonetheless, the banks still have to deal with less developed financial accounting and planning among their clients, and continued close monitoring of the banking sector remains essential. My authorities consider it highly important that external investors see that Latvia is capable of sorting out banking sector problems themselves, and that Latvia has a strong and stable banking system which will be a safe conduit for channeling foreign investment into Latvia. As mentioned by the central bank Governor in a recent speech, they see their banking system as a "window" through which outsiders see the Latvian economy and it is, therefore, important that the view through the "window" is clear and impressive. Accordingly, there should be no doubt that my authorities continue to stand ready to take immediate action if prudential regulations are not respected. Partly related to the importance of strong international credibility in the financial system, earlier this month the Prime Ministers of the Baltic countries signed a joint declaration with the objective of preventing money laundering.

My authorities fully agree that sound macroeconomic and structural policies are complementary and mutually reinforcing, and that the pace of structural reforms must be accelerated. A number of important steps have been taken recently or are under way as described in the staff papers. The Latvian government attaches high priority to liberal external policies in their ongoing efforts toward membership in the EU and the WTO, and several steps are being taken in that regard as noted in the papers. The staff has expressed concern regarding a brief delay in the implementation of the reduction in agricultural tariffs. In the context of the multilateral negotiations to join WTO, my authorities have repeatedly stated their preparedness to negotiate a significant reduction of agricultural tariffs, and they would like to reiterate their intention to implement the planned reduction by the time of the WTO accession or the second review under the Stand-By Arrangement, whichever is sooner. Progress in implementing structural reforms, including trade policy, will be a key focus of the second review under the Stand-By Arrangement.

The staff points out that, even though Latvia compiles the core statistics necessary for surveillance on a timely basis, there have traditionally been some deficiencies as well, particularly for national accounts and balance of payments statistics. My authorities have given high priority to the resolution of the problems, including within the context of preparing for subscription to the Fund's Special Data Dissemination Standard (SDDS). They agree that timely and comprehensive economic and financial statistics of good quality are critical to their ability to assess economic performance and make rational policy decisions, as well as for markets and others to perform their surveillance role. The efforts have been accelerated in recent months. A letter on Latvia's subscription to the SDDS has now been submitted, and the necessary metadata are under way. Accordingly, Latvia should appear soon on the Bulletin Board.

Finally, my Latvian authorities would like to express their appreciation for the considerable contribution of the Fund staff to the reform process in Latvia, and they look forward to continuing the excellent dialogue and cooperation in the years ahead. They are fully aware that the reform process continues to pose important challenges, and they are determined to carry through the ambitious reform and macroeconomic stabilization agenda that will transform the Latvian economy into a vibrant market place and prepare Latvia for full EU membership.

Mr. Yakusha made the following statement:

The case of Latvia could, in general, be considered a success of strong stabilization efforts based recently on the exchange rate peg to the SDR. There is a good chance of inflation being further reduced from a so-called stubborn level of around 25 percent, to below 16 percent this year. The sustainability of the balance of payments is insured by the geographical position, which is an east-west gateway, as well as presence of the biggest Baltic transit port, Ventspils, that provides a steady flow of service payments—accounting for around 40 percent of the merchandise exports in 1996. The net international reserve position has also recently improved due to the resumption of capital inflows. Nevertheless, the country has experienced problems of great magnitude in recent years, for example in 1994/95 when the banking crisis and the subsequent political crisis erupted and when confidence in government policies was somewhat eroded because of fiscal slippages followed by the unsustainable strong growth of imports. There was virtually no economic growth in 1995 accompanied by some signs of financial disintermediation, such as a rapid increase in capital flight. In this context, the Latvian authorities have demonstrated a strong commitment to address these recent challenges in a comprehensive manner.

Following the setback in 1995, economic policies have been strengthened this year, and the overall performance in the balance of payments is good, despite such adverse externalities as the harsh winter and sharp drop in prices for food exports. The authorities have to be commended for decisiveness in maintaining the exchange rate peg through the full-scale banking crisis. This policy response was supported by fiscal and monetary tightening, which was difficult politically, but which eventually paid off. Signs of restored confidence, particularly on the part of foreign investors, are quite promising. The major challenge ahead is a full restoration of confidence in policies on the part of domestic economic agents.

On the fiscal side, the policies of the government are tight enough and even more restrained than envisaged under the program. It is also encouraging that revenues performed better than expected, although the ratio to GDP has not changed much, and the improvement in the overall fiscal position appears to be due to cuts in expenditures. On the other hand, the shortfall in social tax collection and the continued accumulation of some other tax arrears could undermine efforts in achieving a sustainable growth recovery, as budgetary expenditure earmarked for investment might be diverted to current social expenditures. To this end, one should assess positively the intention of the government to have a balanced budget for 1997 while doubling investment expenditures. At the same time, I would like to be informed what the staff would suggest to the authorities in response to possible further deterioration in social tax collection.

On the monetary side, the long-awaited financial sector restructuring is well under way. I commend the Latvian authorities for the success in overcoming the banking crisis experienced in 1995. I would encourage them to pursue cautious policies and to accelerate the pace of structural reforms in order to complement their stabilization efforts. Although the authorities have, indeed, a far-reaching structural reform program, the progress has been somewhat limited so far and administrative controls remain significant.

There is a close relationship between the sluggish progress in restructuring the banking sector and the unsatisfactory performance of monetary indicators and economic activity. The demand for money declined during the banking crisis in 1995 and has not yet improved; the velocity of money stands quite high, and there are no signs of recovery. Furthermore, the currency deposit ratio has continued to deteriorate in 1996, signaling the public's lack of confidence in the banks' performance. The room for maneuver of the central back to conduct its liquidity policy remains narrow, and therefore relies on measures such as high reserve requirements and more recently the centralized system of settlements for foreign exchange transactions.

Interest rates spreads, although significantly lower than four years ago, remain high in real terms, reflecting weaknesses, rigidities, and limited competition in the banking system. Although deposit rates, often negative in real terms, are conducive to low money demand, they also encourage Latvians to keep their savings abroad. In the meantime, high real credit rates discourage emerging private sector growth and might lead to adverse selections, hence the maintenance of a weaker portfolio on the part of the commercial banks. Indeed, Latvia experiences both low deposits and the decline in real terms in credit to nongovernment sectors. Therefore, given the deep roots of the situation, reform would contribute to a fast improvement of the economic environment. Latvian authorities are to be commended for their effort, inter alia, to strengthen supervision aimed at establishing a better foundation for banking activity. However, monetary indicators suggest that confidence in the banking system remains fragile, and that further and significant steps ahead are required. I have some specific areas of actions in mind.

First, numerous small and weak banks typically have high operational costs and quite low performance, mainly because of, but not limited to, the inability of assessing risks. I therefore think that the Latvian authorities should contemplate measures such as high capital requirements and tax exemptions or reductions for provisioning against bad loans, as well as stimulating the merging of small banks. As I recall, for such a small country, Latvia has around 35 commercial banks in place.

Second, the authorities should consider the introduction of a deposit protection scheme, when conditions allow. Repaying only 1 percent of total deposits, as was the case of the bankrupt banks in 1995, is a tough decision that keeps immediate inflation under control and sends a positive signal to the market. Yet, it further undermines confidence in the banking system.

Without a doubt, a healthy economic environment, which would need the acceleration of restructuring efforts, could only consolidate the banking system, and enhance the public confidence in its performance. Based on the reports, I tend to agree with the staff assessment that structural reforms in Latvia are still somewhat lagging behind the desired schedule. My main concern here is also the path of foreign trade liberalization. Some quantitative restrictions on imports are still in place, and tariffs for some agricultural products are too high. I recall in this respect the discussions within the Ukrainian government when the protectionist import tariffs in Latvia were used as an argument in favor of suggestions to protect Ukrainian producers from foreign competition, too. These suggestions were, of course, wrong and the defenders lost their argument so far, but I would urge the Board to consider delays in foreign trade liberalization in program countries not only a regrettable move per se, but also setting a precedent for other transition economies that often need competition from abroad as a real incentive for consistent and radical restructuring in corresponding sectors. To this end, I was pleased to learn that the Latvian authorities will be prepared to move ahead with further foreign trade liberalization consistent with the WTO guidelines.

With these remarks, I agree with the decision proposed by the staff.

Mr. Watal made the following statement:

This chair congratulates the Latvian authorities for their efforts to put on track the monetary and fiscal performance required under the precautionary Stand-By Arrangement. They have done this after going through a fairly difficult period last year. Staff have provided background papers which are exceptional both in terms of their quality and clarity.

The success achieved under the arrangement reflects the determination of the Latvian authorities who have largely complied with the performance criteria under the Stand-By Arrangement. Therefore in this context it would suffice for this chair to make a few comments.

We are in full agreement with the staff observation that the gains in macroeconomic stabilization have not been reinforced by adequate progress in structural reforms. These are to be deepened with proper coordination with and assistance from the World Bank, the EBRD, and other donors.

Latvia's external trade system is liberal accept in the area of agricultural imports. We are happy to note that steps are being taken to reduce tariffs below 30 percent. It seems that the authorities want to go slow on this as it would help in their negotiation for accession to WTO. Staff has advised against linkage between actions under the fund program and negotiation with WTO. We feel that Latvia should not be constrained too much in this respect and should be allowed negotiating flexibility.

The staff has made an observation that economic activity in the parallel economy is considerable. Could the staff comment how this is impacting on the regular market economy and what would be the implications of a thriving parallel economy, in the medium term, on the overall economic system?

The staff has commented that the composition of government expenditure has differed from the program; current spending exceeded the projections and investment fell short. The wage bill was higher on account of bonuses and the budgeted revenue increases have been conservative. It has been mentioned that a Budget for 1997, consistent with objectives given in para 18 of staff paper EBS/96/168 was presented to the Parliament in early October. Could staff apprise us about the current status of the Budget bill and which is pending second reading in Parliament. We would also wish to reiterate that the work on the comprehensive taxpayer identification must be expedited, to improve fiscal performance.

This chair endorses the view of the authorities that the present exchange rate peg to SDR is the cornerstone of monetary policy. But keeping in view the fact that the developments in monetary aggregates have differed from expectations as advised by staff the authorities must monitor external developments closely.

We are also concerned about the continuing weak growth in bank credit to the private sector. A large balance of payments surplus has resulted in greater reserve money growth but coupled with this there has been lower broad money expansion and paucity of domestic credit. The lack of legal basis for collateral, poor accounting and audit practices, and weak enforcement of business regulations has also limited the banks willingness to lend. These issues should be addressed quickly as a sound banking system is essential for orderly growth. This, no doubt, would require deepening of structural reforms in the banking sector. We also agree with staff that a deposit insurance scheme should not be introduced before the banking system is brought onto a sound footing.

I am glad to note that in some key areas the momentum of structural reform has picked up. In the housing sector considerable progress has been made and the new Bankruptcy Law has been duly legislated .The Prime Minister's commitment to the reform agenda, his determination to achieve real GDP growth of 5 percent over the medium term, to continue the transformation to a market economy and prepare Latvia for full EU membership are indeed laudable. The medium term growth rate would seem achievable in light of Latvia's work force which is educated and disciplined. One area of conspicuous vulnerability which must be rectified is too much dependence on electric power needs from abroad. This aspect should be jointly addressed by the authorities and the World Bank.

In conclusion, we feel confident that Latvia will meet its prospective obligations to the Fund in a timely manner hence we support the proposed decision in section V of the staff paper EBS/96/168 at page 31.

Mr. Verjbitski made the following statement:

I would like to congratulate the Latvian authorities on their successful implementation of the adjustment program and the return of Latvia's economy to a more stable macroeconomic environment since the time of the previous Article IV consultation. The authorities are to be credited, in particular, for the considerable tightening of fiscal policy, the firm handling of the full-blown banking crisis, the improved banking supervision, and the prudent stance of monetary policy. In combination, these efforts ensure the sustainability and credibility of the exchange rate peg of the Latvian currency to the SDR in the aftermath of last year's crisis. As I share many of the views expressed by the staff in the most informative papers before us, I shall focus my remarks on several selected issues that might require some further elaboration.

My first observation relates to inflation inertia in Latvia that still remains a big problem under Latvia's fourth consecutive Stand-By Arrangement with the Fund. Of course, traditional yardsticks cannot be fully applicable to a country undergoing transition from a centrally-planned economy with administered pricing to a market-driven system. However, it is not quite clear why Latvia's strong adjustment efforts aimed at restraining demand and suppressing wage growth in the economy have not met thus far with the somewhat more rapid decline in the rate of inflation. While congratulating the authorities on bringing the annual rate of inflation below 20 percent for the first time since 1992, I cannot help asking why did it take Latvia almost as long as Russia to reduce the monthly inflation rate below 2 percent, taking into account much more tight fiscal and monetary policies in Latvia over the years and the strong lasting commitment to maintaining the nominal anchor. I would like to thank the staff for offering an interesting clue to answering my question. Figure 8 on page 23 of the staff report, and figure 7 on page 63 of the RED paper illustrates the trends in bilateral, nominal, and real exchange rates of the ruble vis-à-vis the lats in the period since end-December 1992. Importantly, during that period macroeconomic conditions and exchange rate policies, both in Russia and Latvia, underwent many changes. Nevertheless, astonishingly the real bilateral exchange rate remained stable until present. The striking stability of the bilateral real exchange rate suggests that inflationary expectations in Latvia might have been rather closely linked to the rate of inflation in Russia. The role of Latvia's fiscal and monetary policy in this equation appears to have been primarily limited to supporting the credibility of the exchange rate peg of the lats. Some further study of this phenomenon by the staff may be in order. The apparent existence of a close link between inflation in Russia and Latvia, of course, does not contradict the staff's finding that in the absence of the peg, inflation in Latvia might have been higher.

The staff devotes considerable attention to the question of whether interest rates, after their recent decline, are presently positive in real terms. It is, indeed, a difficult question as interest rates in Latvia are determined by the market. Apparently, without factoring into them the still rather high rate of inflation in the country, the staff suggests that this should be understood by looking at the interest rate through a prism of future lower inflation expectations in Latvia, a method which is believed to be theoretically more appropriate. This method gives some benefit of the doubt to 12-month interest rates, but does not explain the negative levels of real deposit and lending interest rates pertaining to short maturities. In this regard, I feel that an alternative approach to assessing the market behavior in determining both the level of short-term and longer maturity interest rates is more appropriate in Latvia. Under the circumstances of a sustained and credible exchange rate peg in a liberalized financial market environment, the attention of market participants is concentrated on the interest rate premiums in the local market over the rates in the international markets related to the instruments denominated in the currency of the peg. Thus, compared to the SDR interest rate, Latvia's interest rates are currently 500–600 basis points higher, which may be sufficient to attract capital inflows despite the rates being somewhat negative in real lats terms domestically. This may also explain such facts as nonresidents holding a large share of outstanding treasury bills in Latvia, the interest rates in the interbank market have fallen below the refinance rate of the Bank of Latvia, and that there appears to be little relationship between overall banking system liquidity and interbank rates.

On the issue of the delay in fulfillment of Latvia's commitments to reduce tariffs on agricultural imports, I fully support the staff's principal position that conditionality under Fund arrangements should not be compromised by the member's involvement in separate negotiations with a third party, unless the Fund specifically agrees to respective changes in the program. I urge the Latvian authorities not to delay their respective action under the Fund-supported program any further.

Regarding balance of payments statistics, I note that due to more comprehensive coverage of both exports and imports of goods and services to include the re-export trade, Latvia's current account data have been revised from 1995 onwards, resulting in a break in the time series. Difficulties continue in recording invisibles transactions, as services data in the current account may still include some capital inflows. These issues have considerable bearing on the forthcoming discussion on the reliability of the quota calculations of a group of 23 countries, including Latvia, in the framework of the Eleventh Quota Review. I wonder whether the European II Department plans to update soon its own estimates of Latvia's and other European II countries' economic indicators and variables for the period 1991–1993 to measure better their economic size.

In conclusion, I wish the Latvian authorities continued success in their adjustment efforts as spelled out in their updated program, and I hope the progress in the area of structural reform will soon match Latvia's successes on the macroeconomic front. I support the decision to conclude the first review of the Stand-By Arrangement with Latvia, and I agree to the authorities' requested waiver on the nonobservance of one performance criterion.

Mr. O'Loghlin made the following statement:

There was very substantial progress toward implementing a comprehensive system of tax-identification numbers by end-September. This work appears to have been advanced significantly further since then. So it is clear there has been no weakening in the authorities' commitment to this critical—but huge—task. Accordingly this chair supports the granting of the waiver sought for nonobservance of the related structural criterion and, noting that all of the end-September quantitative performance criteria have been met, also supports completion of the present review.

However, although Latvia has essentially met the requirements of the Stand-By Arrangement, I want to mention two key concerns. These, I believe, fully justify the staff's assessment that inadequate progress on structural reforms would raise risks of economic stagnation.

The first relates to the outlook for the balance of payments. Tables 20 and 23 of the RED, taken together, show that the dollar value of wood & wood product exports quadrupled from 1993 to 1995, and that of pulp and paper product exports doubled. These items, which now constitute more than one quarter of all Latvian exports, are crucial to the current account position. Indeed, expansion of these exports accounted for virtually the whole of the increase in export values over the period. In consequence, the balance between forest regeneration and current levels of timber harvesting is also crucial. Can staff elaborate on this balance at present?

It is also noteworthy in its own right that, over the same period, the dollar value of all other categories of exports combined has virtually stagnated. It is far from clear that recent developments in Latvia, at least thus far, signal a potential for volume increases in these other export categories into the future; and the further real appreciation of the lats implicit in staff projections of inflation, in the context of a firm exchange rate, suggests that Latvian business faces a more difficult future on export markets. I should emphasize here that I am not querying the present Lats-SDR linkage. That is a critical economic anchor. Rather, the question is whether domestic cost developments have yet become nearly consistent enough with that linkage, and how to make them more consistent.

There is a related fiscal concern. Economy-wide, wages almost doubled in dollar terms over 1993–95. Producers seem caught between rising dollar-valued wages and the requirements of a competitive market. In that situation, it is unsurprising to find that employment has contracted substantially—by close to 10 percent from end-1993 to end-1995. One wonders how great is the risk that the fiscal consolidation of recent years may be unwound by a vicious circle: is it possible that rising unemployment will drive up outlays; that this, in turn, will force already-high social security charges still higher—in an effort to expand revenues as the workforce contracts; and that increased charges, by impacting adversely on competitiveness, will further depress employment?

These considerations emphasize the importance of progressing certain of the staff's recommendations, especially their calls for accelerated privatization, for encouragement of greater foreign direct investment and for actions supportive of the latter including legal reform and stronger enforcement of contracts together with land reform.

Mr. Schlitzer made the following statement:

We are pleased to see that the temporary setback in the transition process in Latvia and the severe banking crisis that characterized 1995 are being left more and more behind. During the first part of the precautionary Stand-By Arrangement there has been a further and appreciable improvement in the macroeconomic outlook. We note, in particular, that all the July and September quantitative performance criteria have been observed, some of which with notable margins. With fiscal and monetary policies being implemented broadly as envisaged, economic growth has resumed and inflation has continued to decline, falling to below 20 percent.

In this context, the worsening recorded by the external current account provides only limited ground for concern, in our view. In fact, given the increase in government saving, and the resumption of private sector investment, reflected in the large imports of capital and intermediate goods, the larger current account deficit appears to be rather benign. Moreover, largely as a response to the improved outlook and increased market confidence, capital inflows have strengthened substantially, such as to offset the worsening of the current account. Overall, this has resulted in an improvement in the country's international reserves position.

Against these positive developments, we note that progress in structural reforms has been slower than envisaged and that one structural performance criterion has been missed. While we can support the authorities' request for a waiver, we think useful to underscore that macroeconomic stabilization and economic transformation are strictly complementary, especially in transition economies, and hence that they must go hand in hand. If the institutional changes that Latvia requires are not accomplished speedily, so that the bottlenecks on the supply side are removed and the risks of a new financial crisis reduced considerably, growth cannot be long-lasting. That the situation remains fragile in some important aspects is evident in the banking sector, where the currency deposit ratio is still too high, an indication that restoration of confidence is taking longer than expected. Thus, the government cannot afford slippages.

It is also regrettable that, although the overall fiscal objective has been attained, the composition of the fiscal adjustment has departed from its desired trajectory, with public investment falling short of the projections and current spending exceeding them. Clearly, this is not the pattern that we would like to continue.

Concerning the policy strategy that the government should implement in the remaining part of the Stand-By Arrangement, we fully support the staff recommendations. As outlined in the medium-term projections, if this is done, then the economy's growth rate could raise to 4 percent and the inflation rate decrease to 10 percent by 1997. The revised growth and inflation targets are slightly more ambitious than the previous ones, but they are reachable, and should help enhance confidence in the government's action and have a bolder effect in the reduction of inflationary expectations.

I have two remarks on the future monetary and exchange rate strategy, on which I would appreciate staff comments.

As it is typically the case when a peg is adopted, external capital flows complicate the task of monetary policy. I note, in this connection, that the staff recommends the adoption of sterilization measures in the case that large capital inflows resume, an event which is not unlikely given Latvia's good policy and economic performance. I thought we had definitely recognized the limitations that sterilization measures face dealing with short-term capital inflows, and the perverse effect that they, instead, can generate through the related increases in interest rates, which tend to further attract capital inflows. I also recall that our standard recommendation to cope with excessive capital inflows is a faster pace of fiscal consolidation, which helps reducing domestic interest rates. I, therefore, wonder what makes the case of Latvia apparently different.

Another critical issue is that of export competitiveness. Since the adoption of the peg. There has been a continuous appreciation of the real exchange rate vis-à-vis countries outside the region, by almost 200 percent (Fig. 8, p. 23). While I would not disagree with staff that the observed appreciation is in part the reflection of the initial undervaluation of the lats, and that the growth of exports and other factors indicate that margins of competitiveness remain, it is clear that this trend is not sustainable. The expected further reduction in inflation and the productivity increases associated with the accelerated pace of structural reform should help sustain competitiveness. The question is, however, will this be enough to interrupt, and possibly reverse, the current worrisome tendency? Related to this, what does the staff medium-term projections tell us about the effect of the policy strategy envisaged in the program on Latvia's future export competitiveness?

While concluding, I would like to welcome the recent government's decision to subscribe to the Fund's Special Data Dissemination Standards and wish Latvia's government success.

Mr. Leiva made the following statement:

At the outset, I wish to commend the authorities for their quick response to the banking crisis and weakening fiscal situation that emerged last year. In broad terms the authorities' policy actions in recent months were in line with Directors' recommendations during last year's Article IV discussion and have resulted in Latvia's return to the path of declining inflation, positive GDP growth and strengthened external position. I welcome the observance of all quantitative performance criteria to end-September and can support the authorities' request for a waiver on a structural performance criterion. I am in agreement with the thrust of the staff appraisal and will limit my intervention to comment on the importance of continuing with the fiscal consolidation effort and of accelerating the structural reform process.

With respect to the fiscal effort, the slippages in revenue collection in the past forced the authorities to cut spending that disproportionally affected investment and maintenance expenditures. Given Latvia's need for investment in health and education, further cuts could seriously compromise other policy objectives. Thus, most of the fiscal effort in the future should come from the revenue side. In this connection, the fact of having met the revenue floor and overperformed on the fiscal deficit target by 20 percent through September, is commendable. Moreover, despite the initial delays, I welcome the authorities' commitment to complete implementation of the new taxpayer identification system by end-1996.

Another area that requires immediate attention is the significant level of tax evasion and arrears. In this regard, I welcome the measures taken recently to reduce them, in particular the establishment of an Arrears Collection Department within the State Revenue Service. The authorities' intention to initiate liquidation procedures of enterprises that continue to accumulate arrears is also welcome. These measures should serve as a deterrent for other firms from starting to accumulate arrears. Similarly, the transfer of the social tax collection from the Social Security System to the State Revenue Service should contribute to increase the efficiency in the collection of taxes and a reduction in evasion, as it would eliminate some duplication and facilitate cross-checking.

Achieving the fiscal goals of the program, however, will not be possible without maintaining public expenditures under strict control. To that end, I urge the authorities to promptly complete the planned expenditure review to identify areas in which public spending can be rationalized. In addition, improved budgetary management practices should contribute to improve the efficiency and effectiveness of public spending.

In the structural area, I would like to stress that deepening and accelerating structural reforms are indispensable to complement Latvia's stabilization program. The fixed exchange rate system in Latvia has contributed to lowering inflation by providing a nominal anchor and enhancing credibility of government policy. However, inflation is still high and it is expected to remain above that of industrial countries in the near future, thus the "lats" is expected to continue appreciating in real terms. To compensate this real appreciation, significant gains in productivity are necessary. In this context, structural reforms constitute the main instrument through which this can be achieved.

Directors noted last year: "the slow pace of reform and failure to react quickly to the first signs of trouble had resulted in a full-scale banking crisis, with adverse effects on confidence." In fact, the banking crisis contributed to the slowdown of economic activity and the deterioration of the fiscal situation that eventually led to the derailment of the program supported by a Stand-By Arrangement. Fortunately, the authorities were able to contain the crisis. In this connection, the closure of some of the weaker banks and the implementation of stronger prudential regulation and strengthened bank supervision has resulted in smaller but somewhat healthier financial system. In this regard, I share the staff's view that the restoration of confidence in the banking system requires the steadfast continuation of the Bank of Latvia's enforcement of stricter prudential regulations. Looking forward, however, a word of caution is necessary. In an unstable macroeconomic environment the risk of bank failures becoming a systemic crisis will remain high, even if stronger prudential regulations and supervision are in place.

To consolidate the achievements already obtained it is necessary to deepen the reform process and accelerate its pace in several other areas. In this regard, I welcome the authorities' commitment to implement a second generation of reforms, which in my view, play two important roles. They are necessary to provide the right incentives for private sector development and to allow efficiency and productivity gains that enhance competitiveness, contributing to growth and lower inflation. In this connection, the authorities' decision to initiate the privatization of large enterprises is a step in the right direction. Similarly, I welcome progress made in the area of legal reform and of institutional reform, particularly in land registry. Overall, the efficient functioning of a market economy requires a legal and regulatory environment in which property rights and dispute resolution mechanism are clearly defined.

With these remarks I support the proposed decision and wish the authorities success in their endeavors.

Mr. Sobel made the following statement:

Several years ago, I briefly visited Riga. At a foreign exchange kiosk, I observed that dollars were quoted in terms of one unit of domestic currency. I reflected that there was only one other major currency quoted this way and its country had a rather different role in the world economy and history of the international monetary system. I knew then Latvia was a country with self-confidence and dared to be bold.

Staff reaffirms that to considerable degree; Latvia is moving forward self-confidently. Indeed, it is completing phase one of the transition due to praiseworthy macroeconomic stewardship. I agree with many of the observations made by my colleagues on the macroeconomic situation; I would only note that the commitment to sound public finances is strong and this year's fiscal tightening was warranted to reduce inflation, ease pressures on monetary policy and free resources for the private sector. That Latvia has been able to avoid a sharp fall in revenues relative to GDP, contrary to other ex-Soviet economies, is welcome and I ask staff why Latvia has been different. I also agree the current exchange rate level is broadly appropriate from a competitiveness standpoint, however, authorities should not feel themselves locked into rigid arrangements if these at some future point appear untenable.

It is axiomatic that structural reforms are a necessary complement to stabilization for fostering sustained growth. This is particularly so for transition economies, where structural reform encompasses not only privatization and liberalization, but a wide range of legal and institutional changes—bankruptcy, titling, contract law, transparent accounting, stopping corruption, et cetera. While much progress has been made in former Soviet countries on the first phase of stabilization, complexity and vested interests are often slowing microeconomic transformation. Indeed, our greatest challenge in the period ahead will be to achieve a breakthrough on this front.

Latvia's implementation of structural and institutional reforms lags behind progress on stabilization. Latvia needs to be bolder. But for the reforms to be taken, there must first be an agenda; then the agenda must be implemented. What distinguishes today's report from many others on transition economies is that it lays out this agenda in detail. This means a Latvian agenda exists—and I am not fully confident that such well flushed-out agendas exist for many others—and I hope Latvia, working with the international community, will now tackle it vigorously. Hopefully, design and implementation of such agendas will become a wave of the future.

Let me offer some specific points on Latvia's agenda. First, improving tax administration to allow lower tax rates, reforming social insurance, and strengthening public investment are important to ensure that fiscal adjustment is sustainable, a critical second stage transition issue. Second, on financial sector reform, it seems Latvia is springing back well from the 1995 banking crisis, though there is much to be done to shore up confidence, as Mr. Yakusha and Mr. Leiva have suggested. Supervision is importantly being tightened. Bank privatization, another important issue that hopefully will be emphasized increasingly in Fund advice, is being pursued; this process could be strengthened by encouraging entry of private foreign strategic investors.

Third, staff well explains that slow capital market development and the banking system's woes are having considerable impact in crimping lending to the private sector. But given the high currency/deposit ratio, I was not as sanguine as staff that deposit rates could be seen as positive in real terms by virtue of forward-looking expectations. Prima facie, I was skeptical about the argument banks are reluctant to raise deposit rates because depositors might view such increases negatively given past experiences.

Fourth, Latvia's record to date on large-scale privatization and foreign direct investment, its failure to create an SEC, and its high agricultural protection are disappointing and require special attention. I share staff's views in the background report on the design and institutional environment needed for private sector development and on the synergistic benefits of fast privatization for restructuring firms and building financial markets. Thus, on the conclusion that experience suggests privatization need not be undertaken immediately, I would urge that we avoid theoretical debates on sequencing and adopt the Michael Jordan–Nike world view: "Just do it."

Finally, to achieve the staff's medium-term scenario of 5 percent growth, Latvia will need to implement its structural and institutional agenda aggressively. At the same time, given the depressed post-transition GDP base, the educated workforce, and the potential to use capital efficiently under a market system, I thought staff might be a bit conservative. This view was reinforced by staff's assumption of unchanged medium-term capital productivity and its skepticism about productivity growth in the service sector (background report, paragraph 65). Small new firms are prime candidates to generate Schumpeterian forces of creative destructionism; and I would think that given the discouragement of services under the former system, such firms will be able to offer something that is truly demanded and enhances output.

Mr. Yakub made the following statement:

I think we have to recognize that, on the whole, Latvia has made a considerable turnaround this year compared to last year. The fiscal situation certainly looks more stable now. In fact, I think the authorities ought to be commended for the planned pursuit of a balanced budget target for its central government and social security operations in 1997. Inflation is lower than targeted, and the balance of payments also is stronger than projected. Furthermore, the bank supervision is being strengthened. However, I believe it will take some time for confidence in the banking system to be regained, given that the banking crisis of last year is probably still fresh in the minds of investors and the public at large.

I would share Mr. Leiva's point about caution and the risk of bank failure. If we view it over a period of time, the transition process itself for Latvia has no doubt been a bit painful. My impression is that the market forces have not always brought about all the desired results in the restructuring process. Personally, I think we have to be realistic when pressing for the extensive list of structural reforms.

While good progress has been made in line with the Fund program, I think the implication of the tax identification number system appears to be overly ambitious—not that there is anything wrong with being ambitious, but I would prefer being reasonable. Given that there are approximately, if I am not mistaken, 200,000 enterprises that will need to be registered by the end of next month, and they have achieved something like 25 percent of that target, I wonder whether they can realistically be expected to complete that. I would appreciate an update from the staff on this comment. I would support the request for a waiver of the nonobservance of this performance criterion.

My final comment is on the standard Fund package of improved tax administration and ambitious revenue targets. Latvia, whose GDP per capita is approximately $1,800, is being targeted to collect over 35 percent in government revenue, compared to this country, where the U.S. federal government has never even aimed at as much as 23 percent of GDP in revenues. Even if I were to take just the central government operations, and I would exclude, say, the social security taxes—I am referring to Table 4 on page 36 of the staff report—the revenue target is still above 26 percent of GDP. I would appreciate the staff's comment in that regard.

The staff representative from the European II Department noted that the Latvian authorities had been successful in preventing the sharp drop in the revenue/GDP ratio experienced in many other transition countries primarily because of their early shift toward indirect taxation and the introduction of a value-added tax regime, which yielded significant revenues. In addition, the authorities—particularly under the current Fund-supported program—had increased excise taxes. Moreover, given the limited large-scale privatization and the important role of the public sector, the government, in effect, had paid the 37 percent employer's social tax to itself.

The authorities would likely continue to display considerable prudence with respect to the social budget in the event that social tax collection declined, the staff representative continued. For example, the authorities had decided to limit pension increases—required to be indexed to inflation every 6 months—to 3 percent beginning November on 1, 1996, despite the fact that inflation was over 3 percent during the previous six-monthly period. More important, the authorities had introduced a far-reaching pension system that essentially linked social benefits to contributions. The current system would be augmented by a private pension system to be introduced on January 1, 1998. Finally, in the context of the Structural Adjustment Loan negotiations with the World Bank, the authorities were considering postponing the planned reduction of the social tax over the next five years in order to consolidate the medium-term social budget outlook.

The staff had not intended to imply that the Fund-supported program for Latvia would be treated differently from other programs with respect to the possible use of sterilization in response to capital inflows, the staff representative said. Sterilization would be advisable to mop up excess liquidity in the short run; in the event that capital inflows were substantial and not related to an increased demand for money, an adjustment of the exchange rate would be considered.

The staff had expressed its concern to the authorities about the decline in the terms of trade of Latvian wood exports, and the authorities had responded that their strategy was to increase the value added over the next five years, the staff representative noted. Reforestation was also considered an important element of the Latvian wood industry.

While the government had allowed significant wage increases in 1994 and early 1995, there had been no general wage increase recently, and, as a result, real wages had been declining in 1996, the staff representative said. Wage developments in the public sector had spilled over into the private sector, resulting in a slow growth in dollar wages over the previous year compared with growth in other transition economies.

Mr. Verjbitski suggested that the staff should not focus too narrowly on dollar wages, but should include other types of remuneration, such as bonuses, when considering wage levels in transition economies.

The staff representative from the European II Department said that he agreed with Mr. Verjbitski; however, benefits packages had declined recently in Latvia.

Inflation had accelerated rapidly in 1992 in Latvia, but it had decelerated quickly thereafter, particularly in 1996, because of more prudent fiscal and monetary policies, as well as the sharp slowdown in wage growth, the staff representative continued. The downward trend in inflation was expected to continue, thereby reducing the difference between Latvia's price performance and that of its major trading partners and contributing to an improvement in Latvia's competitiveness.

As in all transition economies, the staff representative stated, there had been an initial undervaluation of the Latvian exchange rate; however, it was difficult to determine whether there was a risk of overshooting the real equilibrium exchange rate, given the significant structural changes that had occurred recently and the inability to identify a starting base at which point the economy had been in equilibrium. Difficulties in the area of export competitiveness could be avoided if major increases in investment mobilized Latvia's large human capital stock to generate substantial productivity increases.

The major impact of the significant Latvian parallel economy was to limit the role of financial intermediation, the staff representative remarked. For example, the money/GDP ratio was currently less than 20 percent. In order to benefit from increased financial intermediation and to develop a capital market—vital for private sector development—financial savings in the economy needed to be mobilized and banks needed to be allowed to perform the role of enhancing savings and investment in the economy. As confidence in Latvia's economic prospects increased, the parallel sector would likely increasingly place its savings in the banking system, thereby allowing the economy to benefit as a whole. A second area in which the parallel economy had a significant impact on the overall economy was tax collection. Since the parallel economy provided an outlet for the labor market, tax collection in those areas were reduced, thereby reducing the tax base and forcing the authorities to impose higher direct and social taxes on the formal economic sector. If the parallel economy could be reduced and fully integrated into the economy, then tax rates could decline in Latvia.

Mr. Sobel asked whether the staff approved of the authorities' intention to defer reductions in social taxes.

The staff representative from the European II Department noted that it was conceivable, although not empirically proven, that a reduction in taxes might capture more people in the tax base, leading to increased revenues. However, a closer analysis of the tradeoffs between the different possible methods of financing the social budget would be needed to determine whether that would be the result in Latvia's case.

With respect to the tax identification system, the authorities had issued tax identification numbers to about 48,000 enterprises representing 90 percent of the total eligible enterprises, the staff representative continued. The exercise could be completed by end-1996.

Mr. Verjbitski suggested that the persistence of inflation inertia in Latvia—despite consistently tight fiscal and monetary policies since 1993—was linked to inflation developments in Russia, evidenced by the striking stability of the real bilateral exchange rate between Latvia and Russia. Also, the staff should devote more attention to comparisons among Baltic countries in order to enhance the understanding of the relative economic performance of the three countries.

The Acting Chairman, Mr. Fischer, considered that no link between inflation developments in Russia and Latvia existed, as evidenced by the large differences in price movements in the two countries and the fact that the Latvian nominal exchange rate had risen by a factor of about 10. Also, the significance of the apparent stability of the real bilateral exchange rate—which did not tie inflation rates together, but rather, trade developments—was not clear; more information would be needed to determine how closely the real bilateral exchange rates were tied together.

Mr. Ogushi made the following statement:

> Like other speakers, I will begin by commending the authorities for having managed to bring the program back on track after the setback in the reform process as a result of the banking crisis and fiscal slippages of last year. I hope the authorities will maintain the momentum of economic reform and attain further stabilization of the economy.
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> To this end, needless to say, the authorities should maintain their tight fiscal policy. I urge them to step up their efforts to enhance tax administration and rationalize the spending structure. On the monetary front, while the prospects for inflation look favorable, financial intermediation does not appear

to be functioning well owing to the slow recovery of confidence in the banking system. Pressing ahead with reform of the financial sector and the restructuring of problem banks is critical in order to facilitate financial intermediation active enough to support the growing economy.

Based on the conditions surrounding capital inflows and external competitiveness, I do not think that it is necessary to change the present exchange rate policy. Provided the economy continues to stabilize, the authorities should take this opportunity to press ahead with structural reform. By pursuing privatization and improving the legal framework, among other things, the authorities should be able to create an environment in which the private sector can perform more vigorously.

With these remarks, I support the proposed decisions and wish the authorities well.

Mr. Issaev made the following statement:

We agree with the staff that the general outlook for the Latvian economy has improved considerably since spring. Having observed all performance criteria of the Stand-By Arrangement approved in May, Latvia has taken important steps in overcoming the consequences of the banking crisis and subsequent fiscal slippages at the end of 1995. Firm stabilization policies and strengthened banking supervision have payed off by a resumption of economic growth, by an increase in gross international reserves, and by a decline in inflation. The exchange rate peg of the lats to the SDR has been particularly effective as a stabilization tool in helping to curb inflationary expectations. The significant reduction in government bond yields reflects the credibility of the government's determination in pursuing sound financial policies.

The recent increase in the current account deficit has been caused to a large extent by the deterioration of the terms of trade of wood exports and its effects on the trade balance. Otherwise, exports have expanded at a robust 8 percent, despite a continuing, albeit less pronounced appreciation of the real exchange rate toward its European trading partners. Since intermediary and capital goods account for a large part of imports, the trade gap reflects the need for fundamental economic restructuring and improved competitiveness of the private sector.

On the basis of this evidence, the outlook of a sustainable annual growth rate of around 5 percent over the medium term seems to be well founded. We agree with the staff that given further productivity gains and capital inflows this may even somewhat underestimate the growth potential of the Latvian economy.

Clearly, capital inflows play an important role in financing the current account deficit. It is interesting to note that a large part of these capital transfers were actually from savings accounts held abroad. The sustainability of these particular flows may be questionable. A sign of the uncertainty that characterizes the financial sector in Latvia is weak credit activity by banks to the private sector which has not recovered yet from last year's sharp drop. However, this may also reflect tighter prudential regulation which was adopted in January 1996 as well as stricter banking supervision. As the staff rightly points out, restoring confidence in the banking sector should be a priority for the authorities. Maintaining a stable macroeconomic framework together with implementing the new legislation will be crucial in speeding up this process.

We concur with the staff that the main challenge today lies in accelerating structural reforms. While the swift privatization of state-owned banks is obviously delicate given the present state of the financial system, more privatization involving not only small-scale but large-scale enterprises should be launched. In this regard, the government's intention to privatize nearly all remaining enterprises by end-1997 is most welcome. One wonders, however, about the degree to which this program will depend on cash privatization. Privatization should run in parallel with the development of capital market and active encouragement of foreign direct investment. We would, therefore, urge the authorities to press ahead with the development of investment funds and land reform, notably, land registration. Further necessary legal and institutional reforms will be greatly helped by the structural adjustment program agreed with the World Bank and supported by a SAL.

From a longer term fiscal perspective, we especially welcome the changes in legislation taken by the government to safeguard its social security system by putting it on a sounder financial basis. These steps include raising the retirement age to 60 years, making pensions and social insurance benefits taxable, and allowing for privately managed pension funds.

Finally, we very much welcome Latvia's decision to subscribe to the Fund's Special Data Dissemination Standard.

With these remarks we support the proposed decision and wish the authorities continued success in their future endeavors.

Mr. Schmalzriedt made the following statement:

At this stage of the discussion, I would only like to make a few comments for emphasis, since we can support the proposed decision and the broad thrust of the staff's analysis and recommendations.

First, we commend the authorities for moving ahead on their transformation and stabilization path. We especially welcome the recent efforts to strengthen the budget and banking supervision. We concur with the staff that maintaining cautious financial policies while accelerating structural reforms are of crucial importance. The staff correctly emphasized that, in the absence of substantial progress on structural reforms, the main risk would be economic stagnation. Therefore, in our view, privatization and legal and land reforms have to be given the highest priority.

Second, progress in structural reforms will probably attract additional capital inflows. Such inflows would certainly be welcome but might increase the risk of destabilizing the current exchange rate system. Our preference for a more flexible exchange rate system in Latvia is supported by the results of a recent Fund Working Paper on equilibrium exchange rates in transition economies. The conclusions are, first, real appreciation is the equilibrium outcome of successful transformation; second, the choice of an exchange rate policy is tightly linked to the desired level of inflation; and, finally, real appreciation comes through higher inflation if the exchange rate is pegged to a hard currency.

Mrs. Paris made the following statement:

The Latvian authorities are to be praised for their continued efforts toward macroeconomic stabilization, which is yielding encouraging results, exemplified by the resumption of growth and reduction in inflation. Yet, the pursuit of such a promising path needs, undoubtedly, to be consolidated by the implementation of structural reforms and, on this, I broadly endorse the staff's assessment in the report as well as the main recommendations. As a whole, I am pleased to see a solid understanding between the staff and the authorities on the appropriate program.

At this stage of the discussion, I would like to concentrate on a few issues: fiscal policy, the banking sector and, lastly, inflation and external competitiveness. First, on fiscal policy, although I welcome the fact that revenue slightly exceeded the target, which I recall the staff presented as deliberately conservative in their last report, I share the staff's and the authorities' concern about the continuing buildup of tax arrears. I note that the budgeted revenue increase for 1997 is again conservative and mainly reflects increases in a few tax rates. Does this mean that the current level of tax arrears, around 10 percent of GDP, is supposed to remain constant? I would appreciate the staff's comments. I support the intended increase in investment in the composition of government expenditures, and look forward to the World Bank adjustment operation, which should help rationalize public spending. More generally, I encourage the authorities to devise fiscal objectives in a medium-term perspective. Given the increasing importance of pensions stemming from an aging population, I particularly encourage the authorities to work actively on a reform that would improve the long-term financial viability of the pension system.

Second, with regard to the banking sector, I am pleased to note the efforts undertaken to strengthen the system and the significant progress being made to enforce prudential standards and supervision. While I welcome the continuing efforts to consolidate the Savings Bank, I urge the authorities, like the staff, to ensure the transparency of the privatization process. On the possible introduction of a deposit insurance scheme, I generally understand that the staff needs to stress caution. I would, however, express fewer reservations than they do on measures that could have the merit of strengthening confidence in the banking system. As stated in the letter of intent, such an insurance scheme would be limited in size and be restricted to core banks which presumably are considered to be sound. Such limitations would, in my view, leave little room for moral hazard. I wonder if the staff could further explain their reluctance on this matter.

Lastly, I praise the staff for the quality of the background paper, in particular the chapter dealing with inflationary performance and external competitiveness. Despite the significant real appreciation of the exchange rate, I note the staff's assessment that the margin of competitiveness remains, as demonstrated by the strong growth of exports and the relatively low wage levels. Of course, this would require frequent review. Credibility given by the staff to the hypothesis of structural changes in relative prices—the adjustment to world market levels—as a factor for the persistence of inflation needs to be emphasized. Due attention should also be paid to the suggestion that remaining price differences may result in higher inflation than in most developing countries for a number of years. I believe that this calls for great vigilance against the development of any indexing mechanism, and, as the pace of adjustment slows down, regular tests to ascertain that the real exchange rate does not run the risk of being overvalued.

With these remarks, I support the proposed decision.

Mr. Pascual made the following statement:

Latvia's internal shocks that affected negatively its economic position and caused a severe setback in its output growth, fortunately were of short time duration. It seems that the simultaneous emergence of a banking crisis and a slippage in fiscal policy that marked a pause in the economic reform program during 1995, finally came to an end. Both phenomena that eventually undermined confidence of the economic agents, are the main explanation of last year's economic deviations from the original program projections.

Nevertheless, the track record shows at the present that indeed Latvia has made a remarkable progress in attaining macroeconomic stability. As it is pointed out in Mr. Andersen's buff, this country has made good progress in its economic stabilization process, its structural adjustment program implementation, and its transition to a market economy.

Although, these domestic shocks may be seen as an unavoidable part of the transition process, they also reflect both the fragility of the economy and the serious problems within the banking sector in the country. Fortunately, the authorities have recognized the need to continue with solid macroeconomic and structural policies. With these strong commitments from the Latvian authorities, we do not have any problems in supporting the proposed decision and welcome the authority's efforts to put the economy back on track through their adherence to the economic program supported by the Stand-By Arrangement.

Since 1991, after regaining independence, Latvia's authorities have been faced with the challenges in transforming its economy from a centrally-planned to a market-oriented basis, and started a comprehensive program to stabilize its economy and to achieve a sustainable path of economic growth. During this period, the progress already accomplished is remarkable, successfully diminishing the inflation from almost four-digit levels to 23 percent in 1995, and expecting 16 percent for 1996. Also, in 1996 it is expected that growth will resume with 2 percent.

As other economies in transition, the process of transforming their legacy of centralization into a free-market determined economy has been a difficult task and undoubtedly has been filled with great economic and social problems.

Notwithstanding all the positive results, it is necessary to acknowledge that significant tasks are still ahead. Since we are in broad agreement with the staff appraisal, let me make some comments for emphasis purposes only.

On fiscal, we are pleased with the authorities' steady impetus in the tightening of the deficit management. We urge the authorities to strengthen the tax administration, which undoubtedly would be facilitated with the issuance of the tax identification number. The improvement in the tax administration should be aimed to enforcing the laws on tax arrears and tax evasion, without any exception

On monetary, after the authorities placed a huge amount of treasury bills in the market, the interest rate was falling sharply, in part due to the renewed confidence that the measures were succeeding in stabilizing the economy. Because of lower borrowing requirements by the public sector, the nominal interest rates of bank lending are falling even more. Our main concern is the negative trend that real deposit interest rates have shown practically since December of 1994, although as the staff has pointed out, there was not a conclusive way of determining this evolution.

It seems that this phenomenon in the long term, will affect the domestic savings rate and capital flows. On the other hand, the decline in nominal lending rates does not seem to influence an increasing level of credit to the private sector. Comments by the staff are welcome.

Regarding the pace of structural reform, we concur with the staff that establishing a solid legal infrastructure is the first necessary condition for the private sector development. In this sense, we urge the authorities to move ahead in the legal and land reform, and the process of real assets registration, due to the fact, that these steps are close associated with the successful development of the financial markets and institutions.

Finally, we do not have difficulties in approving the waiver requested, we support the proposed decision and wish the authorities well in their future endeavors.

Mr. Melhem made the following statement:

> The progress made in stabilizing and reforming the Latvian economy under the Stand-By Arrangement is most encouraging. Public finances strengthened, output growth resumed, and inflation declined.
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> This progress notwithstanding, the inflation rate remains above the average prevailing in trading partners. This has led to a real appreciation of the Lats. Although the impact of this appreciation on competitiveness appears to be limited due to the low starting cost structure, the fact remains that sustainability of the fixed exchange rate regime requires further substantial reduction in inflation. In this regard, I am reassured by the authorities commitment to such a reduction. However, achieving the inflation and growth targets for 1997 requires continued tight financial policies along with an acceleration of structural reform.
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> On the fiscal front, I note the progress made in reducing the fiscal deficit. The budget for 1997 is also a step in the right direction. Equally important is the emphasis on shifting from current spending toward investments. Such a shift is necessary to maintain a tight fiscal stance while laying the foundation for sustainable growth. In this connection, timely implementation of all fiscal measures envisioned in the program is essential.
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> The authorities will also need to accelerate structural reform which has so far been lagging. Emphasis on furthering banking sector reform, including the provision of collateral and a transparent legal framework is essential to encourage lending to the private sector. Accelerating large-scale privatization and eliminating impediments to land registration are also crucial for enhancing private sector investment and growth.
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> With these remarks, I support the proposed decision and wish the authorities further success.

The staff representative from the European II Department noted that the level of tax arrears had stabilized recently, and the current problem was that of managing the significant stock of arrears. The government had recently introduced a debt collection unit to monitor closely the situation, and the current Fund-supported program contained various tax administration measures aimed at preventing any further increase in arrears. The acceleration of the privatization process should lead to a lower stock of arrears, either through reflection in the price of firms being privatized or through government write-off of the arrears and liquidation of delinquent firms.

The staff had urged caution—but not opposition—with respect to the introduction of the deposit insurance scheme for the core banks, advising the authorities that ensuring a stable banking system was a prerequisite, the staff representative said. While the staff recognized that such a scheme would add to public confidence in the banking system, the government was reluctant to provide the initial funding for the scheme, thereby shifting the burden to the central bank. Also, some relatively sound banks had expressed the view that such a scheme would, in effect, reward the poor behavior of troubled banks.

The precise measurement of real rates of interest on deposits depended on which inflation rate was used, the staff representative remarked. In the staff report, a backward-looking inflation rate was used and, as a result, deposit rates were negative. However, if a forward-looking inflation rate were used, then current deposit rates would be about zero in real terms. While the level of real interest rates had affected the overall level of deposits in the banking system, other factors, such as the weakness of the banking system, had negatively affected the level of deposits and, consequently, the attempts to increase the role of financial intermediation and the development of a capital market.

Mr. Andersen made the following concluding remarks:

First, I would like to thank Directors for their constructive comments, concerns and good advice. I will, of course, not fail to convey the views to my authorities.

As usual, the staff has already answered comprehensively to the questions and comments raised by Directors, and at this stage I only want to offer a few remarks on some of the issues raised during the discussion.

It seems to be a common feature of discussions on transition economies using the exchange rate as a nominal anchor that the appropriateness of such a fixed exchange rate policy is brought up, including with reference to the inflation rate. Regarding the latter, I would like to stress, once again, that the inflation rate in Latvia has been declining steadily and that the outcome for this year has been even better than expected. It should also be recalled that the inflation rate is still influenced by adjustments in administered prices and in excise taxes.

The lower than expected inflation should be borne in mind when the merits of the exchange rate policy are assessed. So should the fact that the currency was allowed to appreciate significantly in nominal terms before it was pegged to the SDR in February 1994. Furthermore, the pegged exchange rate proved to be extremely valuable during last year's banking crisis and enjoys widespread support in Latvia. Moreover, while it is certainly relevant for this institution to have a continuous close look at the appropriateness of the exchange rate policy, I think we should be careful not to recommend changes in this policy too often, and especially not when the policy has functioned quite well and has earned a lot of credibility as is the case in Latvia. This being said, I also note that there was broad support for the SDR peg, and I would like to reiterate that external developments, including in capital inflows and their composition, are, of course, monitored vigilantly, and my authorities are fully prepared to use the necessary monetary policy instruments in support of their policies. On Mr. Schlitzer's general comment regarding the appropriate advice in case of large capital inflows, let me only note that, in addition to the comments already made by Mr. van der Mensbrugghe, including on sterilization, a significant fiscal tightening is indeed planned for next year. Moreover, my authorities fully agree that to safeguard the competitiveness, improved productivity through an acceleration of structural reforms is of high importance.

Now a few comments regarding the functioning of the domestic money and capital markets, which several Directors commented upon one way or another. There is no doubt that developments here have been strongly influenced by last year's banking crisis, and to some extent this is presumably still the case. Thus, full restoration of confidence is a main challenge as noted during the discussion. However, developments in bank deposits and bank lending in recent months seem to indicate that confidence is gradually returning and, I would like to add, is probably based on more cautious and sustainable assessments, characteristics that are not that bad after all.

Many Directors, if not all, emphasized the need for accelerated structural reforms, and my authorities certainly agree. While the momentum in structural reform has not picked up as strongly as envisaged, many initiatives have indeed been launched and are in the process of being completed. On privatization, this year indeed marked a sharp turning point in Latvia's privatization policy: all large companies, including the main utilities, are now to be privatized, and it is expected that, by the end of 1997, nearly all enterprises in Latvia will be in private hands. Also on trade issues, I listened with great interest to the comments made, including concerning the protection of agriculture. We all know that agriculture is a politically very challenging policy issue. Nonetheless, also in this area, several steps have been taken or are under way and, at the time of the second review, further results can hopefully be reported following a successful conclusion of the WTO accession negotiations. Moreover, we should not lose sight of the fact that Latvia's overall external trade system is virtually fully liberalized, and that Latvia, as a small open economy, of course, realizes the importance of outward-oriented policies, including that considerable benefits can be derived from foreign direct investment, and to promote an environment conducive for such investments is indeed a major objective of the Latvian government.

Finally, on behalf of my authorities, I would like to reiterate their sincere appreciation for the excellent cooperation with the staff, and again I thank my colleagues for their support and valuable comments.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They commended the authorities for Latvia's continued progress in macroeconomic stabilization and economic transformation, and in particular the headway made in strengthening the banking system and addressing the weak fiscal position following last year's difficulties. They were pleased to note that all quantitative performance criteria at end-September 1996 had been observed. Those efforts had contributed to positive economic growth, declining inflation, improving confidence, and a stronger external reserves position. At the same time, Directors noted that a faster pace of structural reform aimed at private sector development was needed to complement the macroeconomic stabilization in order to foster sustained economic growth.

Directors noted that the tightening of fiscal policy had been the main impetus for the favorable results, and stressed the need for continued restraint over government expenditure. While noting that Latvia had avoided the declining revenue-to-GDP ratios experienced in most other economies in transition, Directors nevertheless urged the government to increase its efforts to strengthen revenue collection and tax administration, as tax evasion and tax arrears remained significant. In that regard, Directors noted the importance of meeting the performance criterion on the issuance of tax identification numbers by year-end, and welcomed the progress made in that regard. Some Directors noted the importance of putting the Social Budget on a sounder financial footing and of building up balances to fund future pension liabilities. Expressing concerns on the sustainability of some aspects of government expenditures, Directors urged the authorities to identify areas for rationalization of public spending and to strengthen budgetary management practices. They endorsed the 1997 central government balanced-budget proposal, noting that the budget provided for a doubling of investment expenditure.

Directors noted that inflation, while decelerating, remained excessively high and emphasized the importance of continued prudence in monetary, as well as fiscal, policy. Directors supported the authorities' intention to focus on legal and institutional reforms in order to create a well-functioning credit market, as important complements to the reduction in the price of credit. In addition, a quicker pace of enterprise restructuring should also help promote financial intermediation.

Directors commended the Bank of Latvia for its efforts aimed at building a sounder banking system and, in particular, the strengthening of banking supervision and enforcement of the tighter prudential regulations. Observing that the high currency-to-deposit ratio suggested that the restoration of confidence was taking longer than expected, Directors emphasized that strengthening the soundness of the banking system must continue as a top priority. They urged the authorities to improve the Savings Bank's balance sheet through a credible restructuring and transparent privatization plan, as well as to close weaker small banks. Given the continued fragility of the banking system, Directors generally urged caution in the design and introduction of a deposit insurance scheme.

Directors generally agreed that Latvia's exchange rate policy had been an effective tool for bringing about stabilization, especially during the banking crisis. Some Directors cautioned that capital inflows would need to be watched carefully to prevent inflationary pressures, and they noted that, in such circumstances, an appreciation of the currency should not be ruled out. To maintain and enhance competitiveness, Directors emphasized the importance of accelerating structural reforms to speed up productivity gains, and of ensuring that wage increases remained restrained. Directors welcomed the government's efforts to open further the economy, and urged an acceleration in trade liberalization. Directors regretted the delay in implementing the reduction in agricultural import tariffs, and most stressed that the implementation of undertakings under Fund arrangements should not be linked to negotiations in other international bodies.

Directors stressed the need to complement the stabilization efforts by moving ahead swiftly with the completion of the next phase of transition. In that regard, they noted the importance of accelerating privatization, particularly of large enterprises, encouraging greater foreign direct investment, and developing the capital market. They considered it important to press ahead with legal and land reforms, the registration of real assets, and other institutional reforms. Directors welcomed Latvia's recent subscription to the Fund's SDDS.

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

The Executive Board took the following decision:

1. The Republic of Latvia has consulted with the Fund in accordance with paragraph 3(d) of the Stand-By Arrangement for the Republic of Latvia (EBS/96/72, Sup. 1, 5/29/96) and the letter from the Minister of Finance and the Governor of the Bank of Latvia dated April 24, 1996.

2. The letter dated October 22, 1996 from the Prime Minister and the Governor of the Bank of Latvia shall be attached to the Stand-By Arrangement for the Republic of Latvia, and the letter dated April 24, 1996, with annexed memorandum, shall be read as supplemented and modified by the letter dated October 22, 1996.

3. Accordingly:

(i) the performance criteria as specified in paragraph 3(a) of the arrangement for December 31, 1996 and March 31, 1997 shall be as set forth in Table 2 attached to the letter dated October 22, 1996; and

(ii) the date referred to in the performance criterion set forth in paragraph 3(b) of the arrangement shall be changed from "end-September 1996" to "end-December 1996."

4. The Fund decides that the first review contemplated in paragraph 3(d) of the Stand-By Arrangement is completed and that the Republic of Latvia may proceed to make purchases in accordance with the provisions of the arrangement, notwithstanding the nonobservance of the performance criterion set forth in paragraph 3(b) of the arrangement. (EBS/96/168, 11/4/96)

Decision No. 11380-(96/105), adopted
November 25, 1996

After adjourning at 12:55 p.m., the meeting reconvened at 2:30 p.m.

4. NEW ZEALAND—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with New Zealand (SM/96/269, 10/29/96; and Sup. 1, 11/21/96). They also had before them a background paper on selected issues in New Zealand and a statistical appendix (SM/96/282, Rev. 1, 11/14/96).

Mr. Waterman made the following statement:

Over the past five years the New Zealand economy has been reaping the benefits of comprehensive and sustained reform efforts aimed at achieving macroeconomic stability and improving the structure of the economy. Growth has been strong, inflation has fallen, unemployment has improved markedly, and public debt has been reduced significantly on the back of sustained fiscal surpluses. As the staff report notes, the strength of the commitment to the reform process has been demonstrated by the legislative reforms that have accompanied it.

Growth has moderated somewhat over the past year, but after several years of strong growth this is not entirely unwelcome (or unexpected). There are a number of factors which are expected to support activity over the coming months and prevent a more marked slowdown in growth. Consumer confidence remains high and this together with the impact of the recent tax cuts should help to maintain strong domestic demand. Corporate profits are also high. Reflecting these factors, the authorities expect activity to pick up toward the end of this year or early next year. Over 1996/97 as a whole, the authorities expect output to grow by 2 to 2 ½ percent compared with 3.1 percent in 1995/96.

Price stability remains a high priority. Underlying inflation is slightly outside the 0–2 percent target band at present and monetary policy is directed at bringing it back within the band in the first half of 1997. The monetary policy framework has served New Zealand well as evidenced by the sharp drop in inflation relative to past experience and the significant decline in inflation expectations. The target range for inflation is narrow but as staff note the expectation was that it might not always be met, but rather that the Reserve Bank of New Zealand would continuously aim to meet the target.

Fiscal consolidation continues as evidenced by an overall budget surplus of over 3 percent of GDP in 1995/96 (the third successive year of operating surpluses). The outlook is for fiscal surpluses to be maintained notwithstanding somewhat slower growth, a number of expenditure initiatives in priority areas and the second round of tax cuts. Sustained surpluses over the coming years will continue to support a policy of debt reduction. Net public debt denominated in foreign currency has been eliminated this year. Over the longer term, the authorities expect rising surpluses to be unwound, with the aim of achieving overall balance. This reflects their desire to avoid any substantial accumulation of public assets.

A challenge facing the authorities is how to stage fiscal adjustments (tax cuts and/or expenditure increases) so that the shift in the fiscal stance from increasing to decreasing surpluses does not create inflation pressures and place an undue burden on monetary policy.

The authorities have continued the privatization process. Recently they have pushed ahead with the sale of the Forestry Corporation, Radio New Zealand and the Works Corporation (involved in engineering and construction). The electricity reform process allows for the possible sale of a number of hydroelectric generating stations.

On the external side, determining the level at which a current account deficit is sustainable, is difficult. But I do not believe that the present size of the current account deficit warrants a tightening in fiscal policy. For their part, the authorities consider that the current account deficit is unlikely to inhibit New Zealand's growth performance in the period immediately ahead. Inflation is low and the budget is in surplus. The deficit primarily reflects private saving and investment decisions. The magnitude of direct investment flows is a sign of investor confidence in the sustainability of the CAD and the ongoing commitment of the authorities to sound macroeconomic policies.

Indeed, in recent months there has been a strong increase in offshore investment in New Zealand dollar denominated securities (so-called Euro-kiwi and Samurai issues). The amount issued in the last six months is estimated at NZD7 billion, which is equivalent to about 1½ times the annual current account deficit. Basically, offshore borrowers have been tapping strong investor demand for New Zealand assets—which, because monetary policy is being held firm to reduce inflation pressures, at a time when interest rates in many other markets are low or falling, are offering internationally attractive yields to investors. This has resulted in strong buying pressure on the New Zealand dollar and is presenting the authorities with something of a policy dilemma. Management of domestic inflation pressures, which have been mainly in the nontradable sector, e.g., the residential real estate market, has required maintenance of a firm monetary policy, but the resultant exchange rate movements are placing an uncomfortable degree of pressure on the tradable sector.

While it is difficult to determine with certainty what the impact of structural reform has been on potential growth, the structural reforms, developments in the labor market in terms of labor force participation and improved work practices will have positively influenced New Zealand's growth potential. The authorities have taken a number of steps aimed at increasing labor force participation and improving the quality of labor including through: recent changes to welfare payments which are intended to increase the incentive to seek and gain employment; and the expansion of training programs aimed at disadvantaged groups.

On statistical issues, the staff report notes limitations in the frequency with which consumer price index and capital accounts data are released. In terms of the consumer price index, New Zealand publishes quarterly data. At this stage, the authorities do not consider that there is sufficient demand to warrant producing consumer price index data on monthly basis. Rather, against the background of limited resources, efforts are rightly being directed to improving the quality of the data. In terms of capital account data, the authorities have indicated that efforts are under way to develop quarterly capital accounts.

One final point on the recent election outcomes. Negotiations are still continuing between the New Zealand First Party and the Labor and National Parties over the formation of a Coalition government. At this stage there is still no indication of a likely outcome or the timing of such an outcome. This necessarily creates some uncertainty regarding the policy outlook, but there is general agreement among parties that the broad policy framework needs to be maintained. Developments in both the foreign exchange and bond markets indicate that investors are not expecting any significant shift in policy direction in New Zealand.

In conclusion, my authorities generally concur with the staff policy conclusions, although, as will be apparent for some of my above remarks, carrying these conclusions forward into actual policy in a small, open, economy is not without its challenges.

Extending his remarks, Mr. Waterman said that New Zealand's current exemplary policy framework was all the more remarkable given the country's recent experience. As a small, geographically isolated country, New Zealand maintained a traditional comparative advantage in agricultural production, which faced trade restrictions throughout the world. In the 1960s and 1970s, New Zealand had opted for inward-looking, interventionist policies that had resulted in high inflation, large budget deficits, and an inefficient and inflexible economic structure; at the same time, a high level of internal and external indebtedness had been built up. However, after many difficult years, New Zealand had boldly embarked in the 1980s on a path of significant reforms. While it remained a small, vulnerable economy that might face disturbances in the future, New Zealand currently had a strong and transparent institutional framework that was capable of identifying and facing problems as they arose.

Mr. Sivaraman made the following statement:

We compliment the staff for excellent set of papers on New Zealand. As rightly observed by staff, New Zealand occupies a unique place in the history of reforms. Strong growth in output, increased labor market flexibility, reduced unemployment and budget surpluses are the important outcome of this bold strategy. In addition, external current account deficits have been smaller than in previous periods of sustained growth, foreign direct investment inflows have risen and official external debt has been reduced.

As I am in general agreement with the staff recommendations, let me emphasize the following:

Economic growth has been modest over the past year and will remain subdued in the coming months. This slow down is less sharp than in previous cycles. The slower growth should be treated as a blessing, since output remains above potential. But the interesting point which comes out of staff analysis is that the average growth in New Zealand is much lower than that of other Asian countries and higher to many OECD countries during the period 1995/96. This is very clear if we compare the investment ratios in New Zealand with that of other countries. Although the investment ratio has increased in the last two years, further increase is required, if growth is to be given a boost. Furthermore, on a number of earlier occasions, we have confirmed that growth becomes a casualty in the short- and medium-term of the reform period. New Zealand experience further confirms this view.

Hence the moot question is how to give a boost to output growth. In this respect, the following points are worth considering:

Augmentation of savings in the economy on a priority basis could be a medium-term objective. Even during the high growth periods earlier, substantial increase in savings was not seen. Moreover, in the last 3 years, the real interest rate has increased, but this also has not influenced savings. Hence the authorities must analyze the savings behavior in the economy and take adequate steps to give a boost. In this context, we welcome their plan, as explained in para 41 (page 16). The authorities intention to raise the retirement age from 60 to 65 by 2001 will also have its negative impact on domestic savings.

In view of low savings, the saving-investment gap was financed by foreign savings. Given the current account of deficit of 3–5 percent of GDP, to what extent additional burden could be placed on the draft of foreign savings is not clear. The authorities' view on financing future growth has not come out clearly in the staff papers. Staff may like to elaborate further.

Inflation targeting seems to be a principal objective of government policies with the job of the Governor of the Reserve Bank of New Zealand's being at stake for any inexplicable failure on this front. What is an optimal inflation rate that can subsist with a reasonably high output growth is still a matter of judgment. In a country with a high per capita income and low poverty, inflation targeting could be a prime objective as in New Zealand. New Zealand has succeeded in this endeavor of achieving low inflation levels. In this it can neither be compared with other Asian economies excluding Japan and Korea nor can they exactly emulate New Zealand. At present monetary policy framework has been very effective in containing the inflation rate. But in view of increase in the real interest rate, currency appreciation and widening of current account deficit, monetary policy has been overly tight. Given the fiscal surplus and limited room available in the fiscal policy, how long monetary policy could deliver such low inflation is not clear. To add flexibility to this policy, we favor the idea of widening the band of price stability. Although the wider band provides for absorption of the shocks to inflation which occur between the setting of policy and its impact in inflation, and reduces the need for frequent policy changes, one could also view this as a trade off between flexibility and credibility. However, given the commitment of New Zealand authorities, we do not have any problem in recommending a wider band.

We commend the authorities for their fiscal prudence and support their medium-term strategy.

The recent increase in current deficit although is at manageable level, no doubt carries additional risk. The staff have suggested that the authorities should stand ready to promptly tighten the fiscal policies if needed to prevent any widening of the deficit. We are not clear about this suggestion as the authorities have maintained a fair degree of fiscal surplus in the last three years and how far they can move further. Staff may like to elaborate further.

We feel that the current exchange rate level is in right place. In the last two years, in spite of strong currency appreciation, exports were not much affected, due to productivity gains. The authorities are encouraged to strengthen the policies to sustain these productivity gains in future.

New Zealand experience in reforming the public sector has been remarkably encouraging and no doubt useful to other countries, both developed and developing. Transparency and accountability are the principal objectives of this reform. In particular there are no exceptions to any part of the government, which could either avoid or delay the adjustment process. Among various components of this package, "The Fiscal Responsibility Act" is worth mentioning and in our opinion this forms the central nerve. One should not dismiss the process that this was possible given the relatively small size of the government and the absence of any substantial form of state or local governments in New Zealand. We do admit that reproducing New Zealand's reforms in countries with more complex administrative structures and political systems would be a great challenge. In such complicated set up, this type of reform could be attempted in different segments and then integrated at a later stage.

With these comments, we wish the authorities every success in their endeavors.

Mr. Donecker made the following statement:

First of all, I want to thank the staff for a set of clear and concise papers on New Zealand, including the excellent occasional paper on government reform in New Zealand by Mr. Scott and the working paper on accountability and transparency in the public sector by Mr. Cangiano. It is at times like this when one wishes to have more time at hand to study well-written papers on such interesting subjects. In our job, however, time is a rare commodity and we have to rush from country item to country item in the hope that at least our colleagues back home will find more time to give these documents the full attention they deserve.

In many ways, New Zealand is a fine example of what can be achieved with a courageous and comprehensive reorientation of economic and social policies in the direction of liberalized markets and less reliance on governance. The various New Zealand governments since 1984 deserve high praise for the courage, determination, and perseverance with which they have realized major changes that have resulted in quite a dramatic improvement of the social economic framework, including New Zealand's international competitive position and its standing in the financial markets. At the same time, one should not overlook the fact that such wide-ranging and often controversial reforms would not have been possible without the general acceptance of the need for more reforms among the people of New Zealand and their flexibility to adjust to new challenges.

Sure enough, not all of these reforms were as well-conceived and as successful as the 1989 Reserve Bank Act that mandates price stability as a primary objective of monetary policy and gives the Reserve Bank sufficient independence to pursue this objective. Some of the reforms, such as the controversial 1993 health reform, may have overtaxed the patience and endurance of the average New Zealander. The bottom line of all this is, however, that New Zealand has come through a 10-year period of difficult adjustment and restructuring with flying colors, and its people now deservedly reap the benefits. But as the authorities and the staff are aware, much still needs to be done—for example, to further improve the efficiency of the public sector, in particular the provision of adequate education and health services, and to strengthen the competitiveness of the traded goods sector. It is important that the reform momentum is maintained. Against this background, we agree with the general thrust of the staff's analysis and we support the recommendations contained in the staff appraisal.

With regard to the right policy mix, at this stage of the economic cycle, the leading indicators do not provide a clear picture or message. We agree with the authorities and the staff that fiscal and monetary policy should remain sufficiently tight to help reduce inflationary pressures and to safeguard the sustainability of the external position. In this context, it could be advisable to postpone the second round of the tax cuts planned for 1997 in order to further ensure a soft landing of the economy. The authorities should continue with a medium-term orientation of their financial policies.

With regard to monetary policy and the so-far successful inflation targeting of the Reserve Bank, I would like to underline that much of this success is due to respective fairly unique institutional arrangements, as well as to the authorities' clear and unwavering commitment to the objective of achieving price stability. As the staff rightly points out, this combination has provided a stable anchor for monetary expectations and greatly strengthened market credibility, which is particularly important in view of the structure of New Zealand's balance of payments, the size and openness of its economy, and the country's substantial foreign indebtedness.

Against this background, recent proposals to widen the inflation target band from 0 to 2 percent at present to something like minus 1 percent to plus 3 percent, and/or to lengthen the relevant time horizon, appear problematic. The arguments put forward in favor of such modifications—for instance, that they would make it easier to take better account of inevitable uncertainties in forecasting and lags in the effectiveness—are not convincing. Is it not to be feared, rather, that such modifications might be interpreted by financial markets as an unjustified loosening of monetary policy in support of growth objectives? New Zealand has fared quite well with its present inflation targets—I would rather prefer to call them stability targets—under more difficult economic circumstances. It should not risk losing some of its hard-won credibility in this area. On balance, we would advise, therefore, against the widening of the target band, and/or lengthening of the time horizon at this juncture.

With these comments, I wish the authorities much more success in their endeavors.

Mr. Al-Tuwaijri made the following statement:

New Zealand's prudent medium term strategy is reflected in the economy's continued solid performance. The policy challenge now is to ensure that the mix of broad based expansion, low inflation and high employment will endure. Last year's moderation of growth to a more sustainable pace is an encouraging start in that regard.

I broadly agree with the staff appraisal and have only three remarks.

First, I commend New Zealand's success in holding inflation below that of the trading partners. The continued strong priority for inflation control is clearly well placed. It is also reassuring that the authorities remain alert to the special problems of inflation targeting in a small open economy. I welcome especially the pragmatic approach to avoid possible downside risks of an unduly low and inflexible target. As Mr. Waterman's helpful statement makes clear, the narrow target range is set as a goal in full appreciation that the actual outcome might exceed the agreed range. While this approach may have its advantages, on balance I welcome the authorities' willingness to move toward refinements such as a slight widening of the target band.

Second, while I share the satisfaction over strengthening of the balance of payments fundamentals, the relatively large current deficit poses risks. This is especially the case as the economy is becoming increasingly dependent on capital from abroad. Continued policy credibility is thus critical. In this connection, I can see merit in the staff's recommendation that the fiscal stance be tightened as needed to prevent a further worsening of the current payments position.

Third, the authorities can take satisfaction that structural reforms have paid off in a higher growth potential. As the staff report notes, the recent growth record reflects first and foremost a productivity rise in excess of the average for the rest of OECD. Continuation of this performance will require increased domestic savings and foreign direct investment as well as upgrading of the labor force. However, it is unclear what the prospects are in this regard. Staff comments will be welcome.

Finally, like Mr. Donecker, I thank the staff for an excellent and concise report and wish the authorities continued success.

Mr. Martinez Oliva made the following statement:

This Article IV consultation on New Zealand offers, once more, an opportunity to consider a "textbook" example of radical economic liberalization whose outcome exceeded the most favorable expectation. The reform process started in 1984 enabled the country to better exploit its economic potential, by creating a more favorable business environment, and by establishing new rules for fiscal and monetary policy aimed at their credibility and transparency. In the following years, New Zealand was able to turn its large fiscal deficit into a surplus, and bring down inflation from two-digit rates to the current very low figures.

This year economic results are broadly in line with the good performance already observed in past consultations even though economic activity decelerated sharply and the medium-term perspectives for New Zealand remain satisfactory. Still some areas remain which deserve the attention of the policymakers if the results so far achieved are to be maintained and reinforced.

The main issue I wish to consider is growth. I gladly note that the staff has devoted a particular effort in the analysis of New Zealand potential output growth, and I share the conclusion that the process of liberalization and reform of the economy has contributed to raise the potential growth rate of New Zealand at rates of 3.5 percent or more. The challenge for New Zealand is to achieve growth rates as close to potential as possible in coming years. This is not a small challenge, since according to OECD calculations, New Zealand per capita GDP declined by almost 10 percent relative to the average of industrial countries from 1984 to 1994, and is still well below that average, in spite of the strong output acceleration experienced in the past two years.

Achieving rapid growth will require, among other conditions, higher rates of investment to GDP. Accordingly, I am glad to see from the medium-term projections that the staff expects the rate of investment in New Zealand to increase further. However, I also noted that, the saving-investment gap is expected to persist in coming years, in spite of a rise in the national rate of saving. Indeed, this means that New Zealand will have to rely on foreign saving, and thus be able to count on foreign investment, which has been so far encouraged by the favorable business climate created by the reform and by the favorable growth prospect of the country. A virtuous cycle needs to be maintained between reforms, encouragement of foreign investment and strengthening of reforms through growth and a favorable business climate. Policies aimed at increasing household savings may prove crucial to reduce somewhat the tightness of these relationships , and therefore deserve, in my view, the most careful attention by policymakers.

Turning to the external position of New Zealand, the size of the current account deficit raises concerns, particularly because it is largely attributable to a marked decline of the merchandise trade surplus. This has come down by about 3 points in percent of GDP in 4 years, due to the overvalued real exchange rate (in 1996 about 15 percent higher than in 1993), and the sustained growth of economic activity. The situation raises, perhaps, more concerns than in other high-income economies, given the New Zealand's limited diversification of exports of New Zealand which are mostly primary products. This makes the country vulnerable to international price swings.

Against this background, I am less optimistic than the authorities about the ability of such an economy to absorb external shocks through exchange rate adjustments which, of course, remain crucial in the adjustment process. The capital inflows from abroad represent in fact a permanent source of pressure on the NZ dollar, tending to push it beyond the levels consistent with fundamentals. This situation has created difficulties also recently, and might persist until the market adjusts to the increasing current account deficit (as recently noted by Governor Brash). The vulnerability of the country to international market's behavior is illustrated by the strong capital flows into New Zealand after the October 12 general election, which have pushed the currency up and the interest rates down, both undesired outcomes from the RBNZ's point of view.

The accumulation of substantial current account deficits in past years has resulted into high levels of external indebtedness by international standards. While the external debt has recently come down in terms of GDP, it remains very high, leaving the country vulnerable to external shocks.

Finally, monetary policy has so far successfully pursued its institutional task of keeping inflation within the targets, and the breach of the inflation objective does not seem to have had a negative impact on the credibility of the anti-inflationary commitment of the RBNZ. While it can be argued that the economy might benefit from a broadening of the current target range of 0–2 percent, as advocated by some, this does not necessarily represent the best option at this particular moment, since it might give the wrong impression that the central bank may be yielding to political pressures.

A review of the current monetary framework may nonetheless be in order in the near future, to allow for a larger degree of flexibility in it. In this context, the publication of an index of monetary conditions, as anticipated recently, might also prove a constructive refinement of their current framework, as it might represent an useful tool to signal central bank's policy intentions to the international investors .

Mr. Duenwald made the following statement:

I would like to express my appreciation to Mr. Waterman for a very informative preliminary statement, and to the staff for a clearly written, reader-friendly report.

New Zealand has, deservedly, become somewhat of a paradigm for other OECD countries. Twelve years of far-reaching structural reforms and unwavering commitment to sound macroeconomic policies have resulted in New Zealand turning in some of the best economic performances in the OECD area. Clearly, it is important that robust economic growth be maintained so that past declines in living standards relative to other industrial countries continue to be reversed.

New Zealand appears to have successfully engineered a soft landing in bringing its economy down to a sustainable level of activity. A more marked slowdown in growth over the coming months is not expected, according to Mr. Waterman. That is encouraging. I am less certain about the outlook for inflation. It is appropriate, in the case of an economy having undergone significant structural reform, to be cautious about implementing policy on the basis of uncertain estimates of potential output and the output gap. This point is underlined by the staff's background study, in which a wide range for the potential growth rate of the economy is arrived at. Nevertheless, according to staff there is a broad consensus that output remains above potential. If this assessment is accurate, I would question the authorities' projection that underlying inflation will fall below 2 percent by mid-1997. Indeed, it seems unlikely that current wage and price pressures will moderate within this short time frame. The stimulatory effects of the income tax cuts, uncertain with respect to both timing and magnitude, also add an upside risk to the inflation outlook. Given current and projected economic conditions, therefore, I believe that financial policies in New Zealand should remain tight, and that the Reserve Bank should aim at tightening monetary conditions should inflationary pressures reemerge.

New Zealand is a pioneer of the inflation-targeting framework, and I concur with the staff that this set-up has proven effective in keeping inflation low in the face of strong economic growth and has greatly enhanced market credibility, as reflected in the significant decline in longer-term bond yields since the adoption of the framework. One of the key issues raised in the staff report pertains to the monetary policy framework. In this context, I would question the motivation behind recent proposals to widen the inflation target band from zero to 2 percent to minus 1 to plus 3 percent. Well-defined inflation control targets should signal a strict commitment to price stability while allowing for inflation shocks that fall within the typical standard deviation. Ideally, they should function over the full range of the economic cycle without the need for adjustments. Granted, the proposed new band would not imply any change in the midpoint and markets do not appear to have reacted adversely to the possible change. However, because the authorities are discussing this change when inflation is breaching the upper limit of the current band, a wider band could be perceived as tolerance of higher inflation. The current credibility of monetary policy has come only after a long period of sustained effort and could be jeopardized if a change in the target band is viewed predominantly as a higher acceptable inflation rate rather than as a wider acceptable variance. In this regard, the Reserve Bank's intention to aim continuously at delivering inflation in the middle of the target range is appropriate, given the possibility of forecasting errors and inflation shocks.

Fiscal restraint in recent years has also helped contain inflation pressures during the economic upswing. The authorities should be commended for the impressive improvement in New Zealand's fiscal position thus far this decade. The New Zealand experience illustrates the importance of two axioms often mentioned in fiscal policy advice: (1) budget consolidation is more likely to be successful if the fiscal adjustment takes place primarily through expenditure cuts rather than through increases in taxation; and (2) public sector reforms can significantly enhance the efficiency of the public sector and strengthen financial control. I would note, however, that the unresolved political situation implies a risk of fiscal slippage at a time when the economy already appears capacity constrained. In this light, the staff support for sustained fiscal surpluses is appropriate.

Structural reforms have contributed vitally to creating an environment for sustained growth. Like the staff, however, I believe that further reforms to liberalize the economy are in order. In particular, the privatization process could be accelerated, thus making the relevant product markets more competitive with accompanying efficiency gains. Reforms in the labor market should focus on improving labor force skills and reducing the gap between labor market performance of the different ethnic groups.

On the external front, I concur with the staff that there are risks associated with the present size of the external current account deficit, particularly given the country's vulnerability to external shocks. However, I have some sympathy with the authorities' view that an increase in public savings to lower the external current account deficit is not at present called for. As Mr. Waterman notes, the deficit reflects private investment and savings decisions, and the composition of capital inflows, mainly direct investment, augurs well for sustainability since the deficit is being incurred to increase future productive capacity. Nevertheless, raising the level of private savings should be an important medium-term objective for the authorities. In this regard, further structural reforms will enhance the underlying strength of the balance of payments position.

In closing, let me commend the New Zealand authorities on their bold approach to economic management and wish them well in the future.

Mr. Shields made the following statement:

Like other speakers, I was impressed by the staff papers for the meeting today, not only in content but also in length and style. They were easy to read and relevant to our topic this afternoon. I hope future Article IV reports from other area departments will be structured similarly.

I am pleased with the way that policy is currently being conducted in New Zealand, and, indeed, with the performance of the economy. I think the only major doubt over the last year has been the concern of a number of people that interest rates were increased too much earlier this year, pushing the economy toward the risk of recession; however, it looks as if those judgments have been inappropriate and a soft landing in the economy is being achieved.

Crucial to the way that policy is implemented is the inflation target and the way the inflation target has been used. New Zealand was in the forefront of countries moving to inflation targets and now also in the forefront of those having to use inflation targets at a time last year of high growth and inflation pressures in the nontradable goods sector, including house prices. The performance, so far, has been positive on that front.

On the inflation targets themselves, there are some important issues concerning transparency and possible refinements. Like other colleagues, I am cautious about the notion of increasing the band width, which could have a negative effect on the hard-won and deserved credibility of the authorities. On the other hand, in a small, open economy vulnerable to external price changes like New Zealand, the 0 to 2 percent band is narrow, and there have been pressures over the last year for some modification. While it would not necessarily be wrong to have a slightly wider band, it should be brought about at a time when markets were not likely to view it simply as an excuse to increase the top end of the band. Also, it might be difficult, if the authorities chose a minus 1 to 3 percent range, to explain to the public the rationale for a negative inflation target; the other alternative is to have a central rate and then a range around it. So I think that there are several options that could be considered, but there does not seem to be much evidence for a strong bias in the inflation index in New Zealand, so I would not support anything which would ratchet the central targets upward.

On the question of transparency, given the importance of the underlying inflation measure and the possible disadvantages to credibility of having the Reserve Bank both publish and monitor and, indeed, use it to determine policy, Statistics New Zealand might be better positioned to construct this underlying inflation index. It might be a further step toward total transparency. Also, monthly consumer price index data would seem to me a useful step forward as a way of monitoring how well policy is being carried out and as a way of formalizing much of the informal indicators used to produce inflation projections. Finally, specifying clearly the figure and the time horizon for the inflation targets would improve transparency.

On the operational side of inflation targeting, it is impressive the way that markets have now been able to absorb information and fully anticipate actions of the monetary authorities. As a result, strong measures to try and bring about precise changes in rates are no longer necessary. I think there is an interesting contrast with the way that a policy that uses monetary aggregates or monetary targets often proceeds. If you think, for instance, of the way the Bundesbank operates, there are often periods when there are quite sharp divergences between market movements and the eventual actions by the Bundesbank; the Bundesbank often seems to try to wrong-foot the markets. Hence, the clear differentiation of how these two monetary frameworks work in practice: one—inflation targeting—which is essentially trying to get smooth changes and anticipating in light of all available information; and another—the use of monetary aggregates—which in time produces quite sharp movements and uncertainties in the markets about the way that policy is actually going to develop.

On the mix of policies, it is sensible to stay with the current mix—good fiscal guidelines and monetary policy operating well under the inflation target. The firm monetary policy will eventually impact on the nontradable sector in the way that is desired, and the better-than-expected September quarterly inflation outcome suggests this is happening. Nevertheless, the combination of the large current account deficit and a rising nominal and real exchange rate may be appropriate in current circumstances, but must be monitored vigilantly.

There have been many comments about the exchange rate having become significantly overvalued. It would be interesting to hear from the staff what they think about the current exchange rate level.

On the fiscal strategy, I endorse the maintenance of budget surpluses in order to reduce the country's debt levels, and the intention to reduce government spending to 30 percent of GDP. There is, however, a widely held perception that when there is a new government, public expenditure increases. One consequence of that could be a postponement of tax cuts. I wonder whether Mr. Waterman or the staff have heard any further information of this uncertain situation. Nevertheless, given the likely coalitions, that seems certainly a possible outcome, which would imply some movement away from the framework of the last few years.

Finally, on the banking regulatory system, I continue to be uncertain whether the New Zealand system would be appropriate for other countries in which there is not such overwhelming reliance on banks regulated elsewhere. Nevertheless, I welcome the strengthened requirements for banks to produce quarterly statements of their financial positions and their exposure to credit and market risks. It is also credible that bank directors are now liable to civil and criminal penalties for failing to fulfill their duties. In addition, I would like to emphasize the significant contribution that the new real-time gross settlement payment system will make toward reducing settlement risk.

Mr. Newman made the following statement:

I would first of all like to join other speakers in commending the staff for maintaining the very high standards that have become a hallmark of the New Zealand Article IV documentation over the past few years. Like New Zealand economic policy itself, the papers are highly transparent, both in terms of format and in laying out clearly the differences of opinion between the staff and the authorities.

At this stage of the discussion, I have just a few points to make, as I broadly endorse the staff's analysis and policy recommendations.

New Zealand has undertaken what could be viewed as the most radical economic reform program of any industrial country. The New Zealand authorities deserve high praise for the bold measures they have implemented over the past decade to place financial policies on a medium term footing, increase economic and financial transparency, and to boost the accountability of public policy makers. We hope that the current political uncertainties referred to in the staff supplement do not impede continued prudence in economic policy.

I agree that the reforms outlined in the staff papers appear to have strengthened the economy and improved New Zealand's ability to weather cyclical and external pressures. At the same time, the economy has been operating in a relatively benign external environment. The New Zealand experiment has therefore not yet passed the test of a deteriorating world economy.

In that regard, I appreciated the clarification of the difference of views between staff and the authorities on how vulnerable New Zealand's balance of payments situation might or might not be. Arguments in Mr. Waterman's statement that the deficit reflects private savings and investment decisions rather than poor fiscal policy is reminiscent of the arguments of a former U.K. Chancellor prior to the last sterling crisis. This experience and the staff's argument about the potential for terms of trade fluctuations and the scope for sudden large shifts in external financing suggest that a more cautious attitude on the part of the authorities may be warranted.

Turning to the inflation target, underlying inflation has been at or above the target ceiling for over a year now albeit only modestly. With inflation targeting arrangements, a careful balancing act between credibility and flexibility must be undertaken. While New Zealand's transparent monetary policy framework helps, in the final analysis what the authorities actually do matters more than what they say. This gets back to the question we have posed in previous discussions of New Zealand, namely, how exactly do the authorities decide when and how to respond to economic indicators? Markets so far do not seem to have responded too negatively to the breach of the target, but I wonder how much of a grace period the authorities can secure? Any widening of the target band, which the report cites as a possibility, would have to be handled very delicately if credibility in the government's commitment to tight policies is to be maintained. To reinforce that message, it would seem to make sense to delay any widening until inflation was brought back within the current target range.

The same caution applies to fiscal policy, and tax reduction plans in particular. We agree that New Zealand's large budget surpluses probably allow room for some easing of the tax burden, if balanced by reductions on the expenditure side as well. We would add our voice to the staff's cautionary note, however, that such a move should not in any way jeopardize New Zealand's hard-won stabilization and adjustment gains.

I have a question about the authorities' objective to reduce the role of government to no more than 30 percent of GDP. How did the authorities conclude that this is the optimal size of government? We concur that civil service and welfare reform will be vital ingredients, but I would be interested in hearing whether the authorities have also considered privatization of the pension system, or at least a shift of these activities toward the private sector, given the large share of government expenditures that pensions account for?

I wonder if staff could clarify a couple of statements in the staff report regarding output growth. On page 8, the report states that "there is broad consensus that output remains above potential and, in that sense, slower growth is not seen as unwelcome." (Growth was 2.8 percent in 1995/96, and is projected at 2.5 percent in 1996/97.) In the discussion of long-term growth potential on page 16, a range of 2.75 percent to 3.5 percent is given as the authorities' estimate, and the staff suggests a wider band going as high as 4.1 percent if structural reforms are continued. In these circumstances, and given the decline in inflation, I would appreciate a little more commentary from staff on the magnitude of the output gap and likely trends.

Mr. Kiekens made the following statement:

I join the staff and previous speakers in commending New Zealand's authorities for their continued successful implementation of policies which have resulted in low inflation, declining public debt, high employment, and strong growth. Many industrial countries would be happy to match New Zealand's progress in only a few of these areas. Those who envy these results should take a closer look at the reasons for this success. Mr. Sivaraman observes that New Zealand's success would be difficult to export to larger countries. I agree that attempting to copy the New Zealand model exactly in larger countries would cause trouble, but using the underlying principles and philosophy of the New Zealand model as a policy guide would certainly do no harm.

I would like to focus my intervention on the outlook for the external position.

New Zealand's current account deficit has deteriorated from 1 percent of GDP two years ago to 3.6 percent in the last fiscal year. The staff's medium-term projections indicate that it may deteriorate further to 5 percent within the next two years, and will stabilize at well over 4 percent by the turn of the century.

The government points to the improved competitiveness of the traded goods sector and New Zealand's attractiveness to foreign investors as the main reasons for its confidence about the balance of payments outlook. Indeed, the government attributes the growth of the current account deficit mainly to increased imports of equipment. The resulting expansion of the capital stock will enhance New Zealand's ability to earn the income it will need to meet its external obligations.

However, the staff is not so confident as the authorities. The present size of the current account deficit makes New Zealand more vulnerable to external shocks, particularly given its dependence on commodity imports, the high ratio of it external debt to GDP, the high short-term interest rates on the New Zealand dollar, and the ongoing appreciation of the exchange rate following major capital inflows. On balance, the staff concludes that at its present level, New Zealand's external current account deficit appears sustainable, at least at the present level and under present conditions in the international financial markets. The staff bases this conclusion given the soundness of New Zealand's economic fundamentals, its substantial public sector surplus, and the rising level of private investment.

As Mr. Waterman has observed, it is difficult to judge to what level the current account deficit remains sustainable. Let me therefore adduce some further considerations pointing to the need for caution.

New Zealand's trade balance has deteriorated from a surplus of 3.4 percent of GDP in FY92–93 to a position of near-balance in the present fiscal year. In the coming years, the staff foresees import volumes increasing substantially more than export volumes, probably taking account the behavior of the real effective exchange rate, which appreciated by more than 5 percent last year, and is expected to appreciate by more than 7 percent this year. And although the services account balance improved by about 1.7 percent of GDP during the last five years, this gain could offset only half of the deterioration in the traded goods balance. In addition, the staff does not foresees any further improvement in the net services and transfers account in the medium term.

New Zealand may well be able to finance its current account deficit, which is rather large given its growth rate of about 3 percent, but the costs of doing so will include relatively high interest rates and a worsening balance of assets and liabilities. Indeed, in spite of low inflation, three-month bank bills are paying about 9 percent interest, and the staff projects a further rise to 10 percent. Five-year government bonds also pay more than 8 percent per year.

New Zealand's external assets and liabilities balance went from a deficit of 85 percent to a deficit of 90 percent of GDP over the last five years. In the new environment of higher external deficits and lower growth rates, this deficit is bound to grow even faster. Also during the last five years, the deficit of the investment income account in the external accounts increased by about 3 percent of GDP, reaching a total of nearly 7 percent of GDP this fiscal year. We can also expect further deterioration in this account in the period ahead, at least if the reinvested income of the foreign direct investments is recorded twice, once in the current account as an investment dividend paid abroad, and again in the capital account, as a new foreign direct investment. It seems surprising that the staff's medium-term scenario foresees no change in this deficit for the next five years. I would accordingly appreciate some further clarification on this point.

What policy recommendations can we make in light of these observations?

I think New Zealand needs to prevent a further deterioration of its external competitiveness by avoiding wage increases that outpace productivity increases. During the last fiscal year, real hourly wages increased by 1.4 percent, while labor productivity declined by precisely the same amount. The recent re-emergence of wage pressures should be kept under tight control.

Diversification of exports toward more high-value-added technological products is an process that should be encouraged by promoting research and development. The quality of the labor force should be further improved through better education and training facilities. Also, the GDP ratios of domestic private savings and private investments should be further increased, inter alia by removing any distortionary features of the tax system that inhibit capital formation.

With these remarks, I would like to wish the New Zealand authorities as much success in the future as they have had in the recent past.

Mr. Kyriacou made the following statement:

New Zealand's pioneering and persistent policies of recent years have led to an impressive economic performance. This enviable performance continued in 1995/96 for the fifth consecutive year. Furthermore, while the overall picture remains impressive, the authorities monitor closely developments and are ready to tighten financial policies in order to suppress inflationary pressures if needed. I am in broad agreement with the views of the staff as they are articulated in the clear, concise, and informative staff reports. I will make a few comments on monetary and fiscal policies, attaching particular emphasis on the valuable principles of accountability and transparency that are so widely entrenched in all aspects of reforms in New Zealand.

On monetary policy, I agree with the staff and the authorities that inflation targeting in the context of a monetary policy framework that is characterized by abundant transparency and accountability has greatly enhanced market credibility and has in general worked well for New Zealand. The reduction in uncertainty has, indeed, paid off in terms of lower inflationary expectations. Nevertheless, two brief observations could be mentioned on this issue. First, the use of headline inflation rather than underlying inflation might have been preferable. Second, as the staff clearly states, the policy framework is still being tested by the first episode of upward pressure on prices from tight capacity utilization since the adoption of inflationary targeting. Continued vigilance is, therefore, warranted.

The authorities underscored that they would avoid any changes in the existing arrangements that could be interpreted as a weakening of financial discipline. Nevertheless, they also note that while they are well satisfied with the experience to date, this would not necessarily preclude some modification of the regime in the future—perhaps a widening of the band, given their concerns that short-run supply shocks cannot be fully offset. I agree that this might be a legitimate concern, in that given the firmly established central bank credibility and track record, one should expect that, if warranted, the transition to a slightly modified but still credible regime would be smooth. Nevertheless, one might also wonder whether consideration should also be given to the following thought: Given that the markets are rational, and provided that the central bank's commitment remains intact, under the current ambitious range any deviation which is temporary and for reasons beyond the direct control of the central bank would be recognized as such by the markets, and would be appropriately discounted as inconsequential. In fact, my understanding is that this broadly describes the current situation. Given, then, the flexibility that financial markets already grant to the ambitious range of the monetary framework, why risk changing it?

Turning to fiscal policy, the authorities should be commended for the impressive results that they have achieved, including the budget surplus. It should be noted, however, that their efforts should be maintained, particularly given the current account deficit which, albeit sustainable, is perhaps too high to ignore. The far-reaching reforms achieved in New Zealand in the fiscal area are impressive. Two powerful underlying principles of the public sector reform efforts, namely accountability and transparency, have been instrumental in the process as they have facilitated the public's understanding and acceptance of the reforms and minimized rent-seeking behavior. As a result, the budgetary framework is lean and transparent, and policymakers can focus almost without distraction on medium-term and long-term fiscal objectives and strategy. Against this background, the latest political news from New Zealand could cause some concern. As it is stated in the recent the Fund working paper on accountability and transparency in the public sector reforms in New Zealand, "The simplicity of the political system was critical in the success of the public sector reforms." Of course, as Mr. Waterman indicates in his informative preliminary statement, the markets do not expect any significant shifts in the policy direction in New Zealand, which is encouraging. It is up to the authorities to fulfill those expectations.

Finally, let me return briefly to accountability and transparency, two well understood, widely used, and wisely implemented principles in New Zealand. These principles are dominant, underlying forces in many areas of reforms, such as the monetary framework, the budgetary framework, and bank supervision. It is true that it might be hard to argue about the applicability of specific reforms that have been successfully undertaken in New Zealand to other countries. Nevertheless, valuable and straightforward general lessons can and should be drawn as regards the merits of the fundamental principles of accountability and transparency, whatever the particular country-specific circumstances may be.

Mr. Joyosumarto made the following statement:

We join the other Directors in congratulating the New Zealand authorities in achieving their objectives successfully. We learned that New Zealand has continued to show an impressive performance in its current economic achievement. The economy has slowed down to levels that are more sustainable without overheating as past experience has shown. There is decreasing unemployment, a small external current account deficit, increased foreign direct investment inflows, and a reduction in external debt. This has been the outcome of sacrifice and determination in proceeding with policies of liberalization, fiscal restraint, and inflationary targeting.

On savings, the authorities are on the second round of tax cuts. Although the reduction of taxes has created a budget surplus, I have noticed that New Zealand's savings as a percentage of GDP is low. It is evident that the share of foreign savings in New Zealand investment is increasing. However, with a widening external deficit, we join Mr. Sivaraman in asking what measures are being undertaken to induce increased domestic savings to finance future economic growth.

Furthermore, low income earners typically have a high propensity to consume. Therefore, further tax cuts would exacerbate inflationary pressure. Noting that inflation has fallen, I would be more inclined to promote incentive measures to increase savings in order to absorb tax cuts.

On the labor market, we share Mr. Waterman's remark that the development in the participation rate and improved work practices will positively influence New Zealand's growth potential. The falling unemployment rate and the continued shortage of skilled labor will exacerbate pressure on wage earnings, as is evident from the latest statistics that average hourly earnings are 3.2 percent higher than a year ago. We note and support the government's increased spending on education and increased incentive for participation in the labor force. With recent liberalization policies and growth of the economy we hope that, like Mr. Kiekens, these policies will continue, particularly by liberalizing the entry into the labor force of nationals from neighboring countries. Finally, we wish the authorities every success in the future.

The staff representative from the South East Asia and Pacific Department stated that the staff's estimates of robust productivity growth and economic growth potential of about 4 percent were based on assumptions of higher savings and investment. Those assumptions, however, depended on continued structural reforms, particularly in the public sector and in the labor market. While output performance had been good recently, labor productivity had not grown in line with medium-term expectations, primarily because of higher employment of low-skilled youth and part-time workers. The current above-potential output gap—based on partial indicators such as capacity utilization and other business survey indicators—would likely be eliminated during 1996 or early 1997, beyond which the New Zealand economy would be capable of growing at the projected 3.5–4 percent level.

Despite the 20 percent increase in the real effective exchange rate over the past few years, the staff believed that the exchange rate was not currently overvalued, the staff representative continued. There had been significant improvements in the efficiency and attitude of exporters recently, and they seemed to be committed to make the needed long-term investment and productivity improvements to enhance the positive export performance. Many exporters had been successful in the Australian market, while others—many of whom had never considered such opportunities in the past—were targeting Asian markets, where the current market penetration for New Zealand products was quite minor; particularly good prospects existed in the services sector. Such changes, like other structural reforms, would take time to yield their full benefits, but many exporters were optimistic. Nevertheless, over the medium term, the rate of growth of exports was likely to decelerate.

The authorities had not ruled out the possibility of tightening fiscal policy further in response to a possible widening of the current account deficit, the staff representative said. Indeed, Reserve Bank Governor Brash had stated recently that the scope for tax cuts might need to be revised. There was no clear indication yet whether the new government—which was still in the process of being formed among various potential coalition partners—would fully maintain the previous government's plans to cut expenditures. However, the New Zealand First Party, which was negotiating with both the Labor Party and the National Party, had expressed favor for increased spending on health and education and on law and order.

The authorities' aim to cut expenditure to about 30 percent of GDP over the next five years represented a medium-term target and not a view of what constituted the ideal size of government, the staff representative remarked. Budget surpluses, although diminishing, would remain beyond that period in order to continue to reduce official debt beyond 2000, which would require added expenditure cuts. In that regard, the authorities faced a number of difficult issues, especially reform of the pension system. The pension review was already under way, and preliminary calculations supported the increasing recognition in New Zealand that maintaining the present system would entail significant costs and that changes would be necessary. Conclusions from the review would likely be available by end-1997.

In response to the recent breaching of the upper limit of the inflation band, the authorities had maintained a tight monetary stance with the intention of bringing inflation back within the band as soon as possible—an indication of their commitment to avoid damaging their credibility, the staff representative noted. Inflation figures for September 1996—especially the housing construction index—had been encouraging. In order to reach its objectives, the reserve bank had been placing more emphasis on its quarterly statement and had increased further its openness and transparency. Over the previous year, the authorities had displayed their willingness to take measures, such as changes in interest rates and bank targets, to maintain credibility and achieve the inflation objectives. Also, it was considering publishing its monetary conditions index, although it was not sure how exchange rate and interest rate changes affected inflation or whether the effects of such changes varied over the course of a business cycle. As a result, it had not yet decided to publish the index.

There was widespread support in New Zealand for the inflation-targeting framework, and the authorities had been aware that they had adopted a narrow and ambitious target, the staff representative stated. While the commitment to tight financial discipline was unquestioned, there had been some discussion about whether it was possible to change the target without damaging the newly won credibility. The staff had taken the position that it would not be wise to change the band, if at all, until inflation was within the existing band or clearly headed in that direction.

Mr. Ogushi made the following statement:

> I join other speakers in commending the authorities for having created an economy with a great deal of vitality in the private sector by means of thorough and extensive reform since the 1980s.
>
> While I broadly concur with the thrust of the staff's suggestions on how to deal with the challenges lying ahead, I think the economy has sufficient potential to attain sustained growth over the medium term. Regarding the widening current account deficit, I am of the view that the deficit is rather natural in view of the fact that international trading is the exchange of

consumption between different times, namely the present and the future, and that New Zealand has more promising investment opportunities now.

Last year, then-Minister of the Economic Planning Agency of Japan visited New Zealand to see if there were any lessons to be drawn from New Zealand's structural reform experience. He concluded that there was indeed a lot to learn from New Zealand's experience. I believe there is certainly a lot to learn here not only for Japan, but for many countries. I wish the authorities every success in their endeavors.

Mr. Jones made the following statement:

The New Zealand authorities have for some time been committed to economic reform. They have taken a novel approach; but their policies reflect the common consensus that has come up many times in this Board, namely, that there is no substitute for sound economic management. The program has been characterized by comprehensive deregulation, prudent financial policies, privatization and transparency. These are the key elements of what has become a successful strategy. However, the authorities' decade-long experience with economic reform is a reminder that, even in developed economies, success does not come overnight.

Concerning the external sector, Messrs. Newman and Kiekens have raised a number of issues which call for vigilance with respect to the size of the current account deficit.

The reform process seems to be on course in New Zealand, and I wish the authorities further success.

Mr. Lvin made the following statement:

Since we, as many others, greatly admire the truly wonderful history of reforms in New Zealand, I would like to touch upon only a few, but quite important, questions. It is no surprise that the now quite popular idea of inflation targeting is extensively discussed in the context of New Zealand, which has become the first and the most successful champion of this policy framework. Positive results, in terms of the inflation rate being drastically subdued and safely under control, are obvious and undisputable. However, one can still wonder to what extent this policy might be recommended as a permanent and primary instrument of monetary management. A sort of metaphoric comparison may be helpful here. We are accustomed to semantic borrowing from medicine and health care when talking about policy prescriptions (shock therapy, unhealthy developments, etc.). In this vein, one can compare inflation targeting to a medical treatment aimed at reducing a high temperature to a normal level. Such a treatment is appropriate in the case of sickness, but once back to normal, one cannot be expected to check a thermometer each time a health-related decision needs to be made. In other words, inflation targeting does not seem to be a candidate for a universal and transparent monetary policy, like something proposed by monetarists in the 1970s, for example. Its efficacy as a powerful transitory mechanism should not be underestimated, but its appropriateness as a permanent monetary policy framework is still highly doubtful.

Traditional arguments against inflation targeting can be subdivided into two groups. Some arguments are concerned with inherent limits and even self-contradictions related to various definitions of price stability, to the choice of particular indices, to the measurement bias and accuracy issues, and even to theoretical question of whether there is such a thing as an overall price level and price stability. These arguments seem to be valid, and their significance can be expected only to increase as general inflation pressures abate. Another group of arguments concentrates on whether price stability imposes some extra costs on the economy in terms of potential output loss and, if so, what kind of trade-offs should be deemed optimal and appropriate. These arguments look much less justified theoretically, although they might look quite appealing politically. To end with this issue, some suggest a widening of the current price band. One might come up, however, with a different general proposal—namely, to further reduce the role of discretion in monetary policy and to enhance the role of stable and fixed rules.

On the disagreement between the staff and the authorities over the present state of external accounts, I tend to agree with the authorities. Frankly, unlike Mr. Newman, I see much merit in theories developed by Mr. Nigel Lawson. It seems that any existing current account deficit is totally predicated on private business activities and in no way winds up in the financing of unproductive fiscal deficits. That the New Zealand economy is small and open and subject to external shocks is self-evident, but the actual impact of any future external shock would not be diminished by cutting down present externally-financed capital accumulation. Also, new net portfolio investments are directed to private businesses and affect only their liquidity and solvency. It is not possible to come up with a general judgment about an optimal balance between the benefits of rapid and cheap capital mobilization and the drawbacks of exposure to volatile foreign investor sentiment.

I have two more minor issues about the innovative public sector reforms that have contributed to our knowledge about what can be done and even what should be done to overhaul the civil service. Some unique features of New Zealand, like its size, may have made these reforms relatively easy to introduce and implement. Nevertheless, one may argue that precisely these features might have rendered the New Zealand bureaucracy more responsible, more transparent, and more easy to control, even under the previous policy settings. Thus, larger countries, with their issues of governance being often more acute and more critical, can be actually in more need of such reform.

Finally, a minor clarification of the social policy framework would be welcome. It is commendable that the authorities consider a widening of the gap between welfare benefits and earned incomes the major incentive to remain employed. In this respect, what is going to happen to their unemployment benefits after the guaranteed income threshold has been raised? If these benefits were to remain unchanged, such a reform would easily turn into open subsidization of low-paid and part-time employment, which may effectively lead to decreased or stagnant salaries and imperfect resource allocation without much welfare and employment effect.

With these remarks, we wish the New Zealand authorities further success in their highly promising endeavors.

Ms. Zheng made the following statement:

At this stage, I will be brief. Like other speakers, I would like to commend the New Zealand authorities for their continued sound economic performance in 1996. Among OECD countries, New Zealand took the lead in undertaking in-depth and comprehensive structural reforms and ranks foremost in bearing the fruit of reform within only a short decade. I broadly agree with the staff's appraisal and will comment on the following points.

We see that the general economic environment remains favorable, in particular reflected in the low price level, significant pubic saving, declining external debt, and comfortable foreign exchange reserves. However, certain factors are worth attention when interpreting the economic performance, such as the widening of the current account deficit and persistence of underlying inflation at slightly above the band level. I agree with the authorities that the present magnitude of the current account deficit is still within the safety margin, since the bulk of imports are capital goods. However, the recent trend of declining trade surplus and rising net investment income deficit suggests that the current account deficit is worth attention. Therefore, it will be helpful to know which proportion of investment payments is associated with portfolio investment and which with direct investment. Furthermore, I agree with Mr. Sivaraman that the saving rates in New Zealand are low.

Looking at the historical saving development, saving once peaked to more than 30 percent in 1973 and declined sharply in the 1980s when there were large fiscal deficits on average. With the emergence of fiscal surplus in the 1990s, the still low saving ratio seems to suggest that the private saving is reluctant. Since the private saving behavior is unclear as to its influencing factors, staff's comments are welcome. Besides, I welcome the authorities' plan to encourage retirement savings through superannuation schemes and am interested to know the impact of this measure on future saving trends.

On monetary policy, the authorities' inflation targeting framework has been working well in effectively bringing down inflation in 1980s and keeping inflation roughly within the band. In view of the recent stable but up-biased inflation development, I welcome the authorities' commitment to adhere to the inflation target. However, like Mr. Shields, a slight widening of the band at an appropriate time might bear merit. Secondly, looking at the relationship between inflation and broad money, the projected decline in inflation in 1996/97 seems not to reconcile with the projected increase in broad money (page 24, staff report), taking into account the previous positive relationship between the two elements. Staff's comments are appreciated. Furthermore, the authorities should be commended for the recent improvement in the bank supervision system focusing on public disclosure of credit and market risks.

Public sector performance continued to compare favorably with other major OECD countries, due to the authorities' past bold public sector reform effort. The authorities should be commended for streamlining the tax system in an aim to reduce the distortions in the economy. Such efforts need to be further encouraged so as to improve the environment for private investment. On public sector reform, I wish to thank the staff for two interesting extra papers on public sector reform in New Zealand. The success of New Zealand's public sector reform seems to suggest that the improvement of governance accompanied by effective SOE reforms is a key contributing factor. Besides, the legalization of various reform procedures is another centerpiece to guarantee the government's capacity to influence the economy during the decentralization process.

Finally, I wish to commend the authorities for their official development assistance contribution and hope they will double their effort to reach the UN target.

With these remarks, I wish the authorities further success in their future endeavors.

Ms. Srejber made the following statement:

Since 1984 New Zealand has tried to do "all the right things" and it has been exciting to follow their efforts to see whether the "right policies" also would produce the "right results." Today, it is easy to conclude that New Zealand has reaped substantial benefits for their efforts.

It is always easier to speak about problem countries than about successful countries like New Zealand. Thus, I will limit my remarks to a few comments on the policy mix.

As pointed out by other speakers, effects of structural reforms on the level of domestic savings have so far been rather modest, and the savings investment gap has been closed by a current account deficit. Investors' confidence in the New Zealand economy has, however, been demonstrated by the fact that direct investment has covered a substantial part of the deficit. Given this, I hesitate to categorically state that a current account deficit of approximately 4 percent of GDP is not sustainable for New Zealand but, taking into account a foreign debt level of 80 percent, and furthermore taking into account New Zealand's narrow export base and vulnerability to factors outside its control, it is definitely too large in order for New Zealand to be in a safe and comfortable situation.

Economic growth has slowed, but still there might be a risk for overheating of the economy. The government has for some years now pursued a fiscal policy that, according to traditional definitions, should be characterized as contractionary. The effects of this policy, however, have not been much of a slowdown of growth, as the confidence effect and the effect of other structural measures have outpaced any negative growth stimulus of changes in the budget balance.

At the same time as there are overheating signs in the economy, the authorities have a desire to avoid any substantial accumulation of public assets. In line with this, tax cuts have recently been given, and further tax cuts are planned for 1997/98.

This puts a heavy burden on monetary policy. As inflation already is above the target of 0–2 percent, monetary policy is already tight. Further tightening and appreciation of the New Zealand dollar might have serious long term consequences for competitiveness and the current account.

The balance between these interests is not obvious. It seems to me that the authorities, in practice, accept that in a period of strong growth impulses from structural adjustment there might be a case for accepting that inflation may increase over the target band.

If, however, the inflation is outside its targets for a protracted period, it might seriously affect confidence It thus seems to be a conflict between the inflation target, the fiscal target and the foreign balance. I would welcome any comments from the staff on whether they would think there is indeed such a conflict, and if yes, how this conflict might be addressed.

Mr. Costa made the following statement:

I commend the authorities for the exemplary performance of the New Zealand economy which presents unique characteristics. Suffice it to mention that one of its problems is how to deal with a persistent fiscal surplus which, even after accounting for the announced tax cuts, is projected to rise to 6 percent of GDP by the year 2000. On the monetary front, underlying inflation reached 2.3 percent in the year to September which despite its low level implied a breach of a very ambitious target.

On the other hand, the external sector is showing a rapidly shrinking trade surplus which will soon turn into deficit, contributing to a current account deficit that is expected to exceed 4 percent of GDP. This development is not unrelated to the appreciation of the currency that reached 8½ percent in 10 months from January to October in the wake of substantial inflows of capital attracted by the strong fundamentals of the New Zealand economy as well as by the high domestic interest rates. Undoubtedly, despite some weaknesses, New Zealand is a remarkable success story with an enviable record in terms of growth and inflation.

Against this backdrop three general questions come to mind: Which was the main factor contributing to this success? Will the good performance in terms of growth and price stability be sustainable? and third How relevant is the New Zealand experience to other countries? With respect to the first, staff undertakes a comprehensive comparative study involving 10 other countries to arrive to the conclusion that total factor productivity explains most of the growth in New Zealand in the last five years which is tantamount to saying that growth did not result from more labor or capita. The question remains, however, as to which is the main determining factor. The strength of macroeconomic policies and the overall quality of structural reforms certainly should be mentioned. Notwithstanding the importance of policy complementarities, it would have been useful to assess the relative importance of fiscal adjustment, monetary discipline and structural reforms in order to concentrate on those aspects that may make the New Zealand experience more relevant to other countries. The question here is that the novelty of inflation targeting may cloud the importance of other factors. I believe, in this regard, that the extent and quality of the government reform based on transparency and accountability and focused on outputs rather than inputs is a crucial explanatory factor for the success of the New Zealand experience. In this regard I have found the Occasional Pager No. 140 and the Working Paper 96/122 quite helpful.

Regarding the continuity of the success in terms of stability and growth, a critical test of the inflation targeting scheme will come once a complete economic cycle has run its course, in particular when the economy is near or above full employment. In reading the Selected Issues paper, one can find mixed messages in this regard. On top of page 33, we learn that the sharp reduction in inflation during the past five years was due, entirely, to the absence, until recently, of upward pressure on prices from tight capacity utilization. In the bottom of page 35 we read, however, that New Zealand is the first country to implement inflation targeting over the course of an entire business cycle. In any event, the issue of inflation targeting in the context of a small open economy which was raised by Mr. Waterman in his helpful statement and emphasized by Mr. Martinez Oliva, Mr. Newman and Mr. Kiekens is not fully addressed in the papers. I would like to go one step further than previous speakers and propose, in tune with Mr. Lvin's words, more rules and less discretion.

There are at least two points that deserve more analysis. First, the rate of return of New Zealand financial assets is quite high, particularly if we take into account the fact that the New Zealand dollar has been appreciating continuously. That is to say, far from equalizing returns, exchange rate movements are contributing to make those returns even larger. Since it is not reasonable to attribute this return differential to perceived risk when we are analyzing one of the most successful economies of the world, the question remains as to why this happens?. One reason I would like to mention is the overall macroeconomic impact of capital inflows. Even when a tight stance of monetary policy exerts a downward influence on inflation through high interest rates and currency appreciation, we should not forget the positive stimulus to aggregate demand of large-scale capital inflows that may counteract the expected consequences of a tight monetary policy. Perhaps, part of the New Zealand authorities' problems is that they have underestimated the resilience of aggregate demand in the face of surges in capital inflows.

In this context, the policy response usually given is to tighten fiscal policies even further in order to avoid an excessive appreciation of the real effective exchange rate which may impair the performance of the external sector. The New Zealand authorities, however, have already started a gradual loosening of fiscal policy that will have to be closely monitored in order to assess its impact on aggregate demand and inflation. Maintaining persistently high fiscal surpluses rapidly finds political constraints which became apparent in this year's elections in which the political parties seemed to have competed on the degree of generosity in disposing of those surplus.

In these circumstances, I wonder if staff or the authorities have considered the possibility that a successful small open economy such as that of New Zealand may not be better off with a nominal exchange rate targeting, pegging its currency to the one or several of its trading partners. This would represent a more predictable and transparent alternative than the present one because we would be in the presence of a passive monetary policy, interest rates would come down and the competitiveness of the New Zealand dollar preserved. The strength of the fiscal position would allow, moreover, for a fuller use of counter cyclical fiscal policy. While it can be said that a fixed exchange rate is a suboptimal solution in view of the vulnerability associated with external shocks affecting New Zealand differently than its trading partners, we should keep in mind that a flexible exchange rate is also less than optimal, particularly in the presence of real shocks to aggregate demand originated in the capital account. Moreover, under the present arrangement terms of trade shocks are not fully absorbed by exchange rate changes but rather partly accommodated through the distinction between headline and underlying inflation. Lastly, the increasing diversification of the structure of production in New Zealand will make the external shocks objection increasingly irrelevant.

Finally, I would like to conclude with two specific comments on inflation targeting. First, in page 36 of the Selected Issues paper it is stated that the credibility of the inflation target can be called into question if it is perceived as limiting the economy from realizing its full growth potential because it may be compelling an overly tight policy stance. Leaving aside the fact that the New Zealand experience contradicts this assertion, to the extent that growth was its major success, it seems unwarranted to imply that high rates of inflation would favor growth on a sustainable basis. Second, regarding the refinements to the policy setting such as adjustments to the inflation target and band to introduce more flexibility, I would agree with the authorities that these changes could be interpreted as a weakening of financial discipline. It should be highlighted that the present methodology based on underlying inflation rather than on headline inflation already affords a substantial degree of flexibility.

To conclude, I commend the authorities for the impressive achievements of recent years and wish them a continuous success.

The staff representative from the South East Asia and Pacific Department said that neither data on private savings nor a breakdown between corporate and household savings were available. However, the staff's general impression was that corporate savings had held up well recently owing to the strong profitability of the corporate sector, which was expected to continue. There was some evidence that household savings had been declining, perhaps because of improved employment prospects and the strong increase in property prices. Those factors should not continue to depress savings to the same extent in the future, while changes in the national pensions schemes under consideration would likely have a net positive effect on private savings, given that such changes would make benefits less generous and that pensions currently constituted a high percentage of average wage earnings.

With regard to the rewards for employment and their relationship to welfare payments, the labor market reforms designed to increase flexibility also aimed to raise employment over the longer term, the staff representative stated. There had already been an increase of 3 percentage points in the participation rate over the past several years, and the nonaccelerating inflation rate of unemployment appeared to have dropped to about 6 percent and was expected to decline further as more reforms took hold. At the same time, given New Zealand's history, the staff would expect that a strong safety net for the unemployed would continue, but that reforms would aim to improve the targeting of such benefits and to decrease, to some extent, their generosity.

The relationship between money growth and inflation had been difficult to interpret in New Zealand in recent years, which might have been one of the reasons that the inflation targeting framework had received such strong support, the staff representative noted.

The staff did not necessarily see an inconsistency between inflation targeting and the sustainability of the deficit and the fiscal targets, particularly as the public had been willing to accept continued sizable fiscal surpluses, the staff representative remarked. However, it remained to be seen whether the public would support more sizable increases in the fiscal surpluses in the event it became necessary to maintain the sustainability of the current account as well as the inflation targeting framework.

While it was unlikely that the exchange rate would fluctuate significantly over the period ahead, the staff agreed with the authorities that a further rapid rise in the real exchange rate would have implications for export growth, the staff representative stated. However, it was not clear what the effects would be if the nominal exchange rate were to be fixed at the current stage.

Ms. Srejber noted that, if the current account deficit was considered to be too high and the economy to be overheating, then policies would have to be tightened. However, as the authorities did not seem to desire increasing the fiscal surpluses, the only other policy option would be to tighten monetary policy.

The staff representative from the South East Asia and Pacific Department said that the staff considered that, under current policies, the current account deficit was not too high, but it should not be allowed to increase further. Moreover, the economy was not overheating. The staff was concerned that, if export growth turned out to be lower than predicted or if new spending initiatives were announced, then some of the tax cuts would have to be delayed; that might cause some political problems, because the previous government had announced a tax cut package for July 1996 and July 1997. Nevertheless, the staff would not rule out the possibility that, if necessary, the authorities would tighten fiscal policy.

Mr. Waterman made the following statement:

> I am pleased that a number of Executive Directors commented that the staff has produced what I think is a good and readable report on New Zealand, bringing out the issues in a relatively short compass. I know my authorities would like to thank the staff for its work.

I would just like to pick up on two issues. One is the discussion we have had on the inflation target. I think the right points have been made in that area, and the staff made the point that the authorities accepted that the narrow target was extremely ambitious, but they also recognized that, given New Zealand's experience, they needed to establish their credibility. There has been a debate in recent times about whether the target range is too narrow, but in fact New Zealand has done fairly well to date, in terms of operating within the band. It is slightly outside it at the moment, but the expectation is that it will come back within it within the next six months. I think the point was made that, if you were going to make any change to the current system, you would certainly want to do it from a position of strength—that is, of being within the existing band. Otherwise, I am reminded of that joke about the tourist traveling in Ireland who asked a farmer the way to Dublin. The farmer looked at him in a rather puzzled fashion and said, "Well, I wouldn't start from here." So timing is important if you are going to make changes. If there are any, I think they will be more a matter of degree rather than kind, but we still do not know what is going to happen on that front, because we still do not have a new government in New Zealand.

In terms of the current account deficit, I am rather ambivalent about the Nigel Lawson thesis, but I must say that, compared with where New Zealand was 10 or 15 years ago, the current situation is quite positive: it has a sizable budget surplus, negligible inflation, a low tax rate (at least compared with what it had), no major disincentives in the tax structure, low public investment, but a high level of private investment. One can be a bit more patient about a current account deficit of 3 or 4 percent of GDP than one might have been in New Zealand 10 or 15 years ago.

New Zealand does have currently a reasonable amount of flexibility on the fiscal side. As the staff recognized, Governor Brash and others have said publicly that, if an incoming government wanted to do more on the expenditure side, you would certainly have to think about the second instalment of the tax cuts. So there is a degree of flexibility on the fiscal side. These issues are being debated domestically in New Zealand, and I think there is an appreciation of the issue. But you certainly reach a point where it can be counterproductive, in terms of trying to get a better balance between national savings and investment, by trying to increase public savings too much if the net result is just to get an offset in terms of private savings; you certainly have to look at the aggregate picture.

Clearly at the moment there is strong capital inflow, and that is contributing to the size of the current account deficit. Clearly, if capital inflows were to ease, you would get some natural adjustment in the current account position, although I am the first to recognize that if that adjustment takes place quickly, then the process of internal adjustment can be quite painful.

There were some comments on inflation and wages. The latest advice I have is that, if anything, the measures suggest that wage pressure is actually moderating somewhat and that the wage growth in the year to September 1996 was about 3.7 percent, compared with 4 percent in the 12 months to June

1996. So, as I see the current situation, at least in terms of the current account position, I think it needs to be watched carefully. I do not think New Zealand is at a point where you could argue for a dramatic adjustment in policy to get the current account deficit down, but, as the staff has said, New Zealand's record and preparedness to adjust both fiscal policy and monetary policy is good.

The Acting Chairman said that he took note of the many commendations of the Board for the quality of the staff reports.

The Acting Chairman made the following summing up:

Executive Directors were in agreement with the thrust of the staff appraisal. They commended the authorities for their steadfast implementation over the past decade of rigorous financial policies and comprehensive structural reform in a framework of transparency and accountability. The benefits of that bold strategy were increasingly visible in the form of strong output and employment growth, price stability, and a sharp increase in foreign direct investment. Directors welcomed the authorities' commitment to maintain their present policy orientation over the medium term.

Directors considered that the present financial policy stance of tight monetary conditions and public expenditure control remained appropriate despite the moderation in economic growth in recent months. That stance would help to contain inflationary pressure, ensure the sustainability of the external position, and lay a firm foundation for the resumption of more rapid growth over the medium term.

Directors believed that New Zealand's monetary framework, including the inflation targeting regime, had been instrumental in containing inflationary expectations and securing market credibility for the overall economic reform strategy. While a few Directors thought that a widening of the target band for inflation would allow appropriately greater flexibility for monetary policy, most Directors cautioned against such a move, at least until inflation was brought back within the present target band, so as not to affect adversely credibility.

Directors endorsed strongly the medium-term budgetary strategy, which provides for continuing surpluses, as expenditures are lowered in relation to GDP, implying a steady decline of the public debt/GDP ratio. They urged continued progress with civil service and welfare reforms, in order to create room for additional health and education spending, as well as the accelerated privatization of the remaining public sector trading interests. A number of Directors thought it was advisable to postpone the second round of tax cuts until expenditure cuts could be clearly identified.

While a few Directors were of the view that external current account deficits of the present magnitude were sustainable, a number of Directors thought that deficits of that magnitude posed risks, given New Zealand's vulnerability to external shocks and changes in market sentiment. Directors believed that it would be advisable for the authorities to tighten fiscal policies, if necessary, to prevent any widening of the current account deficit. Financial stability and continued structural reforms would help to maintain the competitiveness of the traded goods sector and maintain private capital inflows.

Directors underscored the importance of continuing with the structural reform process to enhance the country's growth potential. In particular, they proposed perseverance with efforts to raise private investment and saving in relation to GDP, and to improve education and training facilities to raise labor productivity. They welcomed the authorities' commitment to further promote multilateral and regional initiatives on trade liberalization.

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

5. RELATIONS WITH WORLD TRADE ORGANIZATION—APPROVAL OF FUND/WTO COOPERATION AGREEMENT; REPORT OF EXECUTIVE DIRECTORS TO BOARD OF GOVERNORS AND PROPOSED RESOLUTION; AND TRANSMITTAL OF FUND DOCUMENTS TO WTO SECRETARIAT

The Executive Directors considered a staff paper on the approval of the proposed cooperation agreement between the Fund and the World Trade Organization (WTO) (EBD/96/149, 11/19/96).

Mr. Bernes and Mr. O'Loghlin submitted the following statement:

The proposed Fund/WTO Agreement represents a welcome step toward strengthening and deepening cooperation between the two organizations, and thus toward a more effective and coherent multilateral system.

Coupled with the proposed decision on its approval, the Agreement at the same time preserves the position of the Fund on issues which are crucial to us.

This chair believes that the Agreement, implemented in a true spirit of cooperative effort, has much to offer, and anticipates that it will be so implemented notwithstanding any apparent difficulties encountered in its preparation.

Accordingly, this chair supports the approval of the Agreement in the terms of the decision now proposed, and of the associated procedural steps outlined in EBD/96/149.

Mr. Zoccali and Mr. Leiva submitted the following statement:

Last July this chair was less enthusiastic than others with the proposal to formalize early on the procedures of consultation and cooperation between the Fund and the WTO. Our position at that time was based on the efficacy of the informal channels of collaboration established, the different decision-making structure of the WTO and a perceived need to first raise the level of awareness in the membership regarding the mutually reinforcing but distinctive mandates of each organization.

The addendum to the Agreement between the WTO and the Fund wherein the Director General of the WTO states that "in any discussion or exchange of information with the Fund and the World Bank our first and only point of reference will be WTO Agreements and Decisions" does not reassure us in this regard.

The proposal before us now to approve the Agreement specifying in the decisions certain modifications is constructive, so long as the understanding on implementation preserves for the Board the right not to accept any unilateral decision of the WTO regarding information from the Fund that should be treated as authoritative. It should be recognized, however, that even this leaves open a potentially significant point of contention pertaining to paragraph 8. As this could constrain more substantive discussions, including on coherence in global policymaking, every effort should be made to avoid surprises and to ensure that the Executive Board is apprised fully and early on of any potential source of conflict in the application of the Agreement

On balance, at this late stage of the approval process, we see merit in reaching a consensus for going ahead, based on the terms of the decision and associated procedural steps outlined in EBD/96/149. We also look forward to an in depth review of the implementation of this cooperation agreement as soon as sufficient experience has been gained.

Mr. Waterman made the following statement:

We discussed these issues at some length at our meeting on November 8 and at our recent luncheon with the Managing Director. The decision by the WTO General Council adopting the proposed cooperation agreement leaves us in a less than perfect world, but it is the agreement that is the most important thing in the final analysis. I think the way forward proposed by the staff is sensible in the circumstances, namely that we approve the agreement but indicate that we do not accept the General Council's decision where we believe it cuts across that agreement, and particularly the definitive nature of our own interpretation of whether or not something is consistent with the Fund's Articles.

The other proposals in respect to attendance to Interim Committee Meetings, Annual Meetings, and the exchange of documents are consistent with the agreement and our early discussions.

Mr. Sivaraman made the following statement:

I am somewhat confused on this matter. In the paper that was circulated on November 8, 1996 there was an attachment showing a decision of the WTO. The WTO quoting Articles of the Marrakesh Agreement Establishing the World Trade Organization, and of the General Agreement on

Tariffs and Trade, 1994 has decided that the Fund shall submit its views on exchange measures by directing a letter to the Chairman of the DSB. Paragraph 8 of the proposed agreement with WTO mentions that the Fund shall inform in writing the relevant body (including a dispute settlement panel). Now that the WTO has passed this resolution where does the Fund stand? Can the Fund direct its letter to the Dispute Settlement Panel or it has only to send letters to the Chairman of the DSB. This is a question which has to be resolved. The proposed decision contained in this paper seems to me only as an exercise in semantics because by attaching a condition to Article 8 of the proposed agreement by a resolution the WTO has already partially nullified the application of this agreement. So I do not know what we mean by saying in our decision that the decisions taken by either party for the implementation of the agreement will not prevent the effective application of this Agreement in accordance with its provisions. The WTO has already taken a decision on the application of this agreement. So what are we aiming at now? Similarly in regard to the second issue as to what does the Fund stand for, there again the WTO seems to have taken the decision that the Fund stands for the decision-making body and we seems to be still holding on to the view that it would only refer to the entity and the Fund would decide which organ is competent. In this context what is going to be the legal effect of our decision. We already have one decision of the WTO and another decision we may take now on the agreement which differs widely. Still we will be signing an agreement knowing that our views on these two issues are completely different.

I am not a legal expert. I shall be glad for an enlightenment on this complex issue by our legal staff here.

Mr. Ono made the following statement:

I agree with the staff proposal for dealing with the problem currently facing us. Frankly speaking, however, this chair must consent somewhat reluctantly to this proposal, since there does not seem to be any better alternatives to it at this late stage of the approval process. Generally speaking, I prefer constructive, forward-looking thinking to hindsight, and would, therefore, like to emphasize the following three points, despite my ambivalence about some aspects of this negotiation with the WTO.

First, I would like to ask the staff to persist in their effort to have the Fund's position duly reflected in relevant WTO discussions.

Second, like Mr. Zoccali, I also look forward to an early review of the implementation of this agreement.

Finally, we must avoid leading the public to believe that there is discord between the two organizations, since doing so might negatively impact the credibility of the Fund's exchange and trade policy advice under the framework of surveillance.

With these remarks, this chair is ready to accept the staff's proposal.

Mr. Han made the following statement:

I welcome this Board discussion on approval of the Agreement Between the Fund and the World Trade Organization, which will make progress toward legalization of the cooperation between the two important institutions.

While disappointed at the WTO's reaction to the Fund's suggestion on their decision to approve this Agreement, we view the Fund's decision, as specified in EBD/96/149, as a second best protection. Therefore, this chair will not object to the approval of this Agreement, provided that the accompanying Fund decision be effective when disputes of jurisdiction matters arise.

Finally, as I share Mr. Zoccali and Mr. Leiva's concern, it is worthwhile for the Board to have a clear understanding of how effective the Fund's conditional approval of the Agreement will be legally binding to another party entering into the cooperation treaty. In other words, if, on a highly presumptive basis, the WTO fails to regard the Fund's view on the Fund's jurisdiction matters as authoritative, what reaction will the Fund possibly have?

I appreciate that the staff could elaborate on this point.

Mrs. Brizuela made the following statement:

I would like to comment on two issues to which I attach particular importance. First, consultation, coherence, and transparency are three concepts that led this agreement to be negotiated. These three words that exist in the spirit of the agreement appear consistently in the draft that was discussed and are repeated in the statement by the Director General of the WTO on agreement among the two organizations. When the WTO approved the agreement without changing the draft decision reviewed and objected to by the Fund, it did not follow these principles even before the agreement's implementation. At this point, I must confess my concern regarding the pragmatic possibilities of an agreement on the basis of a different level of consultation for each one of the parties involved.

Second, the first proposed decision suggests that approval is based on the understanding that decisions taken by either party for the implementation of the agreement will not prevent the effective application of the agreement in accordance with its provisions. It seems to me somehow that this will not be enough to assure the transparency and the integrity of the agreement. In my opinion, the terms and/or conditions under which the agreement is to be signed must be the very same one for each organization, making sure that either party has to understand fully the extent and limits of their responsibilities before signing it in order to avoid eventual or future reviews of the agreement that could affect member countries. From my point of view, the Fund should then resolve the differences with the WTO before signing the agreement, going back to the terms proposed by the Fund and negotiated by both organizations.

Mr. Evans, Mr. Newman, Mr. Esdar, and Mr. Wijnholds said that they agreed with the statements of Mr. Waterman, Mr. Bernes, and Mr. O'Loghlin.

Miss John stated that she supported the proposed decisions, but she wondered whether the current formulation of the proposed decisions provided a clear understanding that the Fund would not be constrained by the decisions of the WTO.

Mr. Fayolle said that he agreed with Mr. Esdar; however, it was still unclear why the WTO had not addressed the Fund's concerns.

Mr. Waterman noted that the continuation of the positive working relationship that the Fund had had with the GATT would depend on good sense being exercised by both parties. While the WTO General Council had behaved in a less than ideal manner, the proposed agreement would need to be considered in light of its actual operation.

Mr. Andersen said that he supported the comments made by Mr. Fayolle; a review of the agreement, after a sufficient amount of experience, would be appropriate.

Mr. Barro Chambrier remarked that it was regrettable that the WTO Council had approved the proposed agreement without taking into account the changes proposed by the Fund. However, he supported the proposed decision and, like Mr. Zoccali, looked forward to the early review of the implementation of the agreement.

The General Counsel remarked that the staff believed that, in spite of the WTO General Council's decision to disregard the concerns raised by the Fund, the advantages of the proposed agreement far outweighed the possible risks involved in the difference of opinion on a particular aspect. The staff had proposed somewhat imprecise language in the proposed decision because it did not want to overemphasize the differences between the Fund and the WTO, in particular with respect to paragraph 8 of the proposed agreement. As a result, the staff proposed to remind the WTO of a basic principle in international law—namely, that once one enters into an agreement, that agreement must be applied. While the proposed decision might be vague, the staff paper was quite clear and it would be communicated to the WTO, along with the Fund's understanding of paragraph 8. In particular, it would be made clear that the Fund considered that the agreement should be implemented as it had been drafted and approved. If, as a result of the General Council's decision, there were a violation of paragraph 8 as understood by the Fund, then the Fund could make a representation to the WTO that the practice in question was inconsistent with the agreement. For instance, if a panel were to disregard a decision communicated by the Fund on the exercise of the Fund's jurisdiction, then the Fund's Board could make a representation to the WTO that such a move was inconsistent with the agreement.

Mr. Sivaraman asked whether, in the case of a Dispute Settlement Body panel, the Fund would inform the Chairman of the DSB or the chairman of the panel; the WTO General Council had decided that the Fund should address its communication to the Chairman of the DSB.

The General Counsel considered that such an example was one of the possible problems that could arise. Perhaps the Fund could address its letter to the Chairman of the DSB for transmittal to the panel, thereby making it clear that it was not for the Chairman of the DSB to decide whether or not the panel would consider the substance of the Fund's opinion. However, a problem would arise if the Chairman of the DSB were to decide to disregard the letter.

The Acting Chairman clarified that the Fund could send letters to whomever it considered appropriate.

The General Counsel noted that there did not seem to be any inconsistency with the agreement if the Fund were to address its communications to the Chairman of the DSB for transmittal to a specific panel.

The Acting Chairman remarked that the operation of that procedure would figure in the eventual review of the agreement.

The General Counsel stated that a review of the agreement could be suggested at some point in the future, not only if the Fund were to conclude that the WTO was not acting consistently with the agreement, but also to clarify the substance of paragraph 8 or to agree on a procedure for the proper implementation of that provision.

Mr. Sivaraman suggested that the WTO should be notified that the intention of the Fund would be to address any communication to the Chairman of the DSB for transmittal to the chairman of a panel.

The General Counsel noted that the WTO General Council had stated that the Fund's letter would "be made available" to the chairman of the panel, while in the Fund's view the letter should be "transmitted" to the chairman, which was slightly different.

The Executive Board took the following decisions:

Fund/WTO Cooperation Agreement

The Executive Board approves the proposed Agreement Between the Fund and the World Trade Organization as set forth in EBD/96/85 (7/5/96) on the understanding that decisions taken by either party for the implementation of this Agreement will not prevent the effective application of this Agreement in accordance with its provisions.

Decision No. 11381-(96/105), adopted
November 25, 1996

Amendment of Section 5 of By-Laws and Proposed Resolution

The Executive Board adopts the Report of the Executive Board to the Board of Governors, annexed hereto, proposing an amendment of Section 5 of the By-Laws, set forth in EBD/96/149 (11/19/96).

Since the matter should not be delayed until the next regular meeting of the Board of Governors, the Board of Governors is requested, pursuant to Section 13 of the By-Laws, to vote without meeting on the Resolution contained in such Report. To be valid, the votes must be received at the seat of the Fund before 6:00 p.m. Washington, D.C. time, on January 8, 1997. Votes received after that time will not be counted.

The effective date of the Resolution of the Board of Governors shall be the last day allowed for the voting.

The Secretary is authorized to take such action as he shall deem necessary or appropriate to carry out the purposes of this decision.

Decision No. 11382-(96/105), adopted
November 25, 1996

ANNEX

Report of the Executive Board to the Board of Governors Proposing an Amendment of Section 5 of the By-Laws

The Fund has recently entered into an Agreement with the World Trade Organization (WTO), and the WTO Secretariat has requested that it be afforded permanent observer status at the meetings of the Board of Governors. However, under Section 5 of the By-Laws of the Fund, only ad hoc invitations to meetings of the Board of Governors can be extended, except in the case of the United Nations where the 1947 Agreement between the Fund and the UN provides that the UN shall be entitled to send a representative to all meetings of the Board of Governors.

It is recommended that a similar invitation be extended to the WTO Secretariat. Therefore, it is proposed that the Board of Governors approve an amendment to Section 5 of the By-Laws set forth below to provide permanent observer status to the WTO at the meetings of the Board of Governors, in light of the interest in cooperation between the two organizations.

RESOLVED:

That Section 5 of the By-Laws shall be amended by adding the following paragraph:

"(e) The World Trade Organization shall be entitled to send a member of the Secretariat as an observer to meetings of the Board of Governors."

Relations with World Trade Organization—Transmittal of Fund Documents to the WTO Secretariat

The Decision on Exchange of Documents with Other International Agencies, adopted February 11, 1993, shall be amended to add the following sentence:

"In addition, documents referred to in paragraph 11 of the Agreement between the Fund and the World Trade Organization may be transmitted to the World Trade Organization Secretariat on the sixth working day after their circulation to Executive Directors, provided that there is no objection by the member concerned."

Adopted November 25, 1996

6. SECRETARY—RESOLUTION OF APPRECIATION

The Executive Directors unanimously adopted a Resolution of Appreciation to Mr. Leo Van Houtven on the conclusion of his service as Secretary and Counsellor.

The Executive Board adopted the following resolution:

WHEREAS on November 30, 1996, Mr. Leo Van Houtven will retire as Secretary and Counsellor of the Fund, having served since August 1, 1977 as the Fund's Secretary, and since May 1, 1987 as Counsellor; and

WHEREAS Mr. Van Houtven has indefatigably and devotedly sought to foster the spirit of international cooperation and to work for the realization of the ideals which the Fund was established to promote; and

WHEREAS a succession of Managing Directors, Executive Directors, and staff members have found Mr. Van Houtven to be a wise counsellor and valued friend;

NOW THEREFORE IT IS RESOLVED: That the members of the Executive Board express to Mr. Van Houtven their sincere appreciation of his long and distinguished service to the Fund and to those associated with it, and their deeply felt wishes for rewarding activities in the future.

Adopted November 25, 1996

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/104 (11/18/96) and EBM/96/105 (11/25/96).

7. PENSION COMMITTEE—NOMINATIONS

The Executive Board approves the election of the Executive Directors nominated to serve as members of the Pension Committee for the term ending October 31, 1998, as set forth in EBAP/96/120 (11/15/96).

Adopted November 22, 1996

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 94/87, 94/90, and 95/39 are approved.

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/96/192 (11/19/96) and EBAM/96/193 (11/21/96), and by an Assistant to Executive Director as set forth in EBAM/96/191 (11/14/96) is approved.

10. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/96/119 (11/20/96) is approved.

APPROVAL: June 27, 1997

REINHARD H. MUNZBERG
Secretary