NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/87

10:00 a.m., June 23, 1993

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	B. R. Fuleihan, Temporary
T. C. Dawson	
	J. Prader
	J. A. Solheim
	T. Kanada, Temporary
K. P. Geethakrishnan	
	K. -T. Hetrakul
	K. Link
	G. Bindley-Taylor, Temporary
K. G. Kagalovsky	A. V. Mozhin
G. Lanciotti	J. Papadakis
	I. Martel
	P. A. Merino, Temporary
	O. Kabbaj
	M. A. Hammoudi, Temporary
	B. S. Dlamini
L. J. Mwananshiku	
	J. Dorrington
	O. Havrylyshyn
	A. R. Ismael, Temporary
S. Schoenberg	
A. S. Shaalan	
D. E. Smee	G. F. Murphy
	A. M. Tetangco, Jr.
	S. McDougall, Temporary
Zhang M.	
	N. Mancebo, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present

IBRD: C. Pant, Europe and Central Asia Regional Office; J. B. Sokol, Latin American and the Caribbean Regional Office. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; J. Berengaut, H. W. Bredenkamp, P. C. Hole, R. J. Ossowski, H. Schmieding, A. Sundakov. External Relations Department: J. Starrels. Fiscal Affairs Department: E. F. Offerdal. Legal Department: R. B. Leckow. Monetary and Exchange Affairs Department: M. Blejer. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, D. Burton, T. Kosugi, V. Kramarenko, A. K. McGuirk, J. P. Pujol. Research Department: S. P. Tokarick. Secretary's Department: A. Mountford. Southeast Asia and Pacific Department: J. H. Felman. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J.-P. Amselle, S. P. O. Itam, G. G. Raymond, S. Sheybani, B. C. Stuart, F. van Beek, J. E. Zeas. Advisors to Executive Directors: P. Bonzom, R. F. Cippa, G. Y. Glazkov, Y. Patel, A. Raza, A. Törnqvist, J. W. van der Kaaij. Assistants to Executive Directors: D. A. Barr, Chen M., M. Dzervite, S. S. Farid, R. Ferrillo, L. Fontaine, N. F. Gregory, M. E. Hansen, E. Kotova, K. J. Langdon, G. Lindsay-Nanton, B. M. Lvin, F. Moss, S. del C. Olgiati, C. F. Pillath, N. Prasad, S. K. R. Regmi, F. A. Sorokos, A. Viirg, S. Vori, Wang X., J. B. Wire.

1. UKRAINE - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Ukraine (SM/93/115, 5/26/93, and Sup. 1, 6/21/93). They also had before them a background paper on recent economic developments in Ukraine (SM/93/121, 6/11/93).

Mr. Havrylyshyn made the following statement:

On behalf of my Ukrainian authorities I welcome this first Article IV consultation for Ukraine, which I believe will greatly help reaffirm their commitment to a meaningful stabilization and reform process. I also wish to express my authorities' gratitude for the intensive and fruitful policy dialogue they have been conducting with the staff, and through which they have been able to draw upon the experience of the Fund in designing a reform program. The extensive technical assistance activities of the Fund have been equally important in this process.

The conclusions and recommendations of the staff's extremely lucid, thorough, and well-balanced report were on the whole fully embraced by the Ukrainian authorities, both in a preliminary version of the end-mission aide-mémoire and the report itself. Only a few small points of interpretation, nuances, and emphasis are worth raising.

One may summarize the main message of the staff report in the following way. Most of 1992 was a year of policy drift, or in the words of the new Prime Minister who headed a new government in October 1992, "a year of lost opportunity for economic reform." The new Government, with the active contribution of Fund staff, has undertaken a radical shift in policy orientation, with, first, a focus on the need to bring inflation under control through a restrictive monetary policy, and second, a reinvigorated effort to proceed with structural reforms, including price liberalization, privatization, current account convertibility, and foreign trade liberalization. While the program certainly has shortcomings, as noted by the staff and recognized by the authorities, the major reason for the mixed results so far has not been in program orientation, or the uncertainty of commitment by the Government to reform, but in a number of serious institutional hindrances to effective implementation.

To understand better the achievements and shortcomings in the Government's reform efforts since October 1992, it may be helpful to review them in the framework of the Board's conclusions at the time of the pre-membership review on April 2, 1992, summarized in the last paragraph on page 1 of the staff report. At that time, Directors emphasized seven points needing attention: a delineation of economic policy responsibilities; a strong commitment to a a program of coherent policies, in particular, financial stabilization; lifting of price controls; privatization in all sectors; foreign trade liberalization; normalization of foreign exchange arrangements, including current account convertibility; and finally, development of a comprehensive program of stabilization and reform in consultation with the staff. This list of tasks provides even today an excellent set of benchmarks against which my authorities themselves assess progress on reform.

The short but active history of transition economies has already taught us both the importance of clear delineation of economic policy responsibilities, and the enormous difficulties of finding a quick resolution to this. In Ukraine, this has been achieved only in a narrow sense of responsibilities within the Cabinet, and only partly. On a broader front, many issues of governance continue to be unresolved. It seems to be an unfortunate common theme in all countries undergoing economic transformation that the parallel process of resolving constitutional and governance issues goes through cycles of heightened political debate and relative stability, as these societies grope, each in their own conditions, toward democratic forms. This perhaps inevitable process has the unfortunate consequence of occasionally slowing down or putting on hold progress in economic reform. I think the record of my Government shows its perseverance in maintaining efforts at reform in the face of these problems.

The second point noted was a strong commitment to a program of mutually supportive policy changes. There is absolutely no question about the commitment of the Government to deal with inflation and jump-start the reform process. Both the more general statement of objectives in the plan of action described in the background paper on recent economic developments, and the recent concrete efforts to exert control over credit issues described in the staff supplement, attest to this commitment. I would like to note in particular the acceptance by Parliament on May 18 of the monetary program of the National Bank of Ukraine (NBU), the introduction of the first auctions for central bank credit, and the substantial increase of the refinance rate to 20 percent per month, a rate very similar to the auction results.

A third step--lifting price controls--has also moved forward, albeit in discrete steps, and incompletely. The staff's characterization of pricing policies as an intensification of control reflects two problems. In key product areas, especially energy, the supply situation is extremely critical and an adequate solution has not been found to implement the Government's plans for world pricing in the face of massive resistance. For other products, a large part of what may be seen as "informal" regulation of prices is a reflection of the problem of implementation at lower levels of government policy set at higher levels. My authorities certainly do not deny that this is a serious shortcoming of the process, but it is a rather different problem from one of a government reluctant to proceed with price liberalization. Finally, the use of profit margins or similar price-regulating mechanisms as an anti-monopoly tool is recognized by the authorities as far from ideal. Again, the difficulty is institutional hindrances to quick implementation of appropriate monopoly regulation mechanisms. It is to right this error that the Government seeks better operational control over the Anti-Monopoly Committee.

With respect to the fourth item the Board emphasized last year--privatization--the hindrances to moving forward have been particularly severe and provide no comfort to my authorities; indeed, they are perhaps the source of their deepest disappointment. The beginnings that have been made in retail outlet auctions, adjacent farm plots, and corporatization are considered by the Government as far from satisfactory.

A far greater sense of satisfaction prevails with the achievements on foreign exchange arrangements and foreign trade regulations, points five and six of the Board's conclusions. Less than two months after taking office, the new Government resolutely introduced the karbovanets as a temporary but full-fledged currency, thereby exiting the ruble zone and setting itself on the course of responsibility for its economic policies. There followed several steps in a movement toward internal convertibility, including the liberalization of foreign exchange operations, the unification of multiple exchange rates, and the establishment of currency auctions. The positive results of this are two. The inevitable devaluation of the karbovanets against the ruble was finally allowed to happen over the period November 1992-February 1993 to reflect the large balance of payments deficit. Since that time, the karbovanets has depreciated significantly, but moved much more in line with the ruble, reflecting the inflationary pressures in both economies. Foreign exchange markets, while still rather unsophisticated, are now in place and functioning relatively efficiently, as exemplified by the fact that actual cross rates for the karbovanets to the ruble no longer deviate substantially from implied cross rates, as they did before May.

On foreign trade, several Government decrees in early May went a long way to liberalize foreign trade operations, as noted in the staff supplement, particularly the sharp reduction of export taxes and quotas.

The Board discussion last April encouraged the authorities to develop, in consultation with the staff, a comprehensive program of stabilization and reform. While much remains to be done in the fruitful dialogue begun in December 1992, it is noteworthy how much progress and convergence there has been in this process, including recent implementation of several measures in line with staff recommendations, notably on tightening credit policy and foreign trade liberalization, as described in the staff supplement. Agreed-upon plans for discussions in mid-May on a possible program under the systemic transformation facility were delayed by the emergence of internal discussions of governance issues, but no one is more desirous of seeing a resolution of these issues and a return to the dialogue than my authorities.

In the difficult process of adjustment, and the even more complex double problem of economic and political transformation, one sometimes hears the claim that a country is unique, is at the crossroads between here and there, and therefore faces obstacles particular to itself. Ukraine and its people do not wish to be unique, or to be at a crossroads. They wish to be like other nations and other peoples, free to enjoy the privileges of personal liberty and economic opportunity, and to be part of that seamless web which is the international community. The road ahead is still long and difficult, and like other nations traveling the same road, Ukraine will have to rely largely on its own resources. It is aware that the hindrances on this path may sometimes result in what appears to be a wavering, hesitant progress, but the direction to be traveled is clear. Continuation of the devoted efforts of assistance by the Fund, Bank, and other members of the international community will nevertheless be needed and appreciated. Ukraine also appreciates the contribution this institution and the international community have made to assist on this journey, by comprehending the nature of this journey and the tremendous importance Ukraine attaches to achieving its end.

Mr. Kagalovsky made the following statement:

I welcome the opportunity to discuss economic developments in Ukraine, one of the largest countries currently undertaking the ambitious transition from a centrally planned to a market economy. I appreciated Mr. Havrylyshyn's statement, which explicitly outlines the major concerns about the economic performance. Not only was the year 1992 largely lost for coherent reforms, but an environment unfavorable for managing a strategy of transition to the market in the immediate future was created during the year, making that transition more costly.

It could be debated whether or not a critical mass of the authorities' commitment to market reform is in place in Ukraine. What should be the cornerstones of the economic strategy under the given circumstances could also be debated. On top of that, it is the evident absence of implementation mechanisms that prevents the commitments from materializing. It seems that for the first time--to the best of my knowledge--the staff report turns to such essential and politically sensitive issues as the clarity of responsibilities and the mandates of the various governmental institutions. Apparently the Fund has not faced this problem so far in the majority of its member countries. This issue deserves more specific attention. If it is conceived as a problem of redefining the role of the state in the countries in transition, research into this issue could advance the understanding of the very nature of such a transition. It is to be hoped that the case of Ukraine will trigger an analysis by the Research Department of the transition from state intervention to state regulation of the economy, moving to a market system.

In the case of Ukraine in particular, with the remaining conflicting interests of the various state institutions and powers, the classic macroeconomic recipes were largely misused, bringing results greatly different from those anticipated. The whole set of instruments for budgetary and credit policies was narrowed to a set of rather straightforward, tight, tax-based wage policies, while, at the same time, the nonviable enterprises enjoyed a complete lack of financial discipline, which was inspired by lobbying pressures of various ministries and agencies with unclear functions and of doubtful necessity. Unclear rules of the game impeded the implementation of the privatization program and left the enterprises with uncertain ownership and control statutes, thus blocking meaningful investment policies.

The inherent contradictions of the policies prevented the economy from providing a positive response. Thus, prices that were liberalized in January 1992 fell back under state control by the end of that very month, and then were raised in a disorderly fashion more than once, bringing disincentives to producers and a deterioration in the standard of living of consumers.

Ukraine was one of the first countries of the former Soviet Union that introduced its own national currency, thus obtaining a powerful tool for macroeconomic management. This step, which can only be welcomed in itself, was not supported by the appropriate monetary and fiscal policies, and the potential gains were thus largely lost. The changes in international trade regulations seem to have torpedoed, rather than promoted, the development of trade. As noted in the staff report, even the improvement in the reserve requirements was seen as another tool for allocating resources on a centrally planned basis, rather than as an instrument of monetary control.

Huge injections of ruble credit were made in the middle of 1992. This allowed Ukraine to distribute the inflation tax on all the countries of the ruble area--primarily on the Russian Federation--but it could not help to revitalize growth. Both net domestic assets of the banking system and broad money grew during 1992 at a pace of 25-30 percent a month. That was the combined effect of the inconsistent increases in administered prices, the existence of off-budget funds, support for non-viable companies, and the two interventions of the central bank--one, a loose operation to monetize net interenterprise arrears of krb 600 billion, and the other, krb 336 billion of direct financing to the agriculture, oil, and mining sectors.

Following Mr. Havrylyshyn's focus on the future, I will make several points on the projected changes in the policy stance.

Recognizing that delays in financial stabilization only bring more pain to the reform process and deprive the authorities of macroeconomic instruments, the National Bank of Ukraine prepared the quantified monetary program and was ready to stop allocating funds to public enterprises. I was about to join the staff in commending these steps when I learned from the supplement to the staff report that the NBU's plan did not receive appropriate endorsement. Legal and regulatory frameworks started to improve and a certain streamlining of international trade procedures was attained, but the country still keeps to the administrative regimes of prices, wages, and international trade, which are seen as financial adjustment measures. Mr. Havrylyshyn points out that Ukraine is not in a unique position and does not want to be at the crossroads between here and there. That means only that the treatment of the country's economy should be brought more into line with the traditional--or, if you will, orthodox--prescriptions that have already been tested by other economies in transition. Looking to the future, my major concern is whether or not the priorities of macroeconomic stabilization measures are understood correctly, and whether or not the phasing of the practical steps would be done in a noncontradictory manner.

Little attention is paid still to the fundamental weaknesses of the national institutions, be that tax administration or the privatization process. Bank supervision remains weak, which is quite natural, given that the regulatory framework, enforcement powers, and number of trained staff are inadequate to the task of supervising an increasingly decentralized banking system. The technical assistance provided by the Fund and by the Netherlands central bank is highly commendable, as is the assistance provided by the central banks of Austria, Finland and the United Kingdom.

State orders still account for almost 75 percent of turnover for 1200 commodities. State control over prices has also not been eliminated. Underlying this ambivalence are the ongoing debates about the "chicken-or-egg" problem of a liberalization of prices in a monopolistic environment. The staff emphasizes that "neither competition nor markets can be created in a vacuum; they are in part the result of the dynamic process brought about by price and trade liberalization." Monopoly abuses--so frightening to the authorities to date--could be tackled primarily by structural measures, thus providing ample opportunities for new entrants, rather than by the administrative manipulation of prices.

In terms of making a prompt contribution to the positive changes in the economy of Ukraine, I would stress the importance of continued massive technical assistance in virtually all the major areas of policy formulation. The Fund's surveillance role should be re-enforced to prevent new contradictory measures from being taken and to bring the required order into international payments arrangements. We welcome the transformation of the country's external arrears to the Russian Federation into debt obligations of the Ukrainian Government. This allows the Russian Federation to proceed with the financing of the Ukrainian trade deficit. More than half of the $12 billion in price subsidies that were provided by Russia to the other countries of the former Soviet Union in 1992 went to Ukraine. Yet, even in this area, regulatory weaknesses hindered efficient resource allocation in the economy of Ukraine. While the current anti-export bias hinders the promotion of exports, it does not prevent commercial consumers from illegally re-exporting Russian oil and gas, which are delivered to Ukraine at prices 40 percent lower than the world level. Of the 25 million tons of crude oil imported from Russia in 1992, 8 million tons were smuggled to third countries. The current arrears to Russia on energy products overall are estimated at $200 million.

Since the ambiguous developments of the past year complicated the overall reform process, I would not hold to the over-enthusiastic belief that the national authorities might be left to manage the reform on their own terms. At the core of the vicious circle of inflation and continued decline in production is the deterioration in the terms of trade, which is considered by the staff as a foregone conclusion. Under the present circumstances, Ukraine cannot afford not to pass on to users--on the grounds of the balance of payments, the budget, or efficiency reasons--the full cost of imported energy or the rising cost of coal. In the absence of adequate external financing, this raises the prospect of further cuts in imports of energy and raw materials, with potentially severe consequences for economic activity. This is precisely the right time for building a program aimed at overcoming the present economic crisis with the Fund's assistance. I share all of the staff's concerns about the authorities' lack of articulated commitment and the uncertain political situation. Nevertheless, I would urge the Fund's management not to delay building a program that could be supported by the systemic transformation facility. In the view of my authorities, the provision of timely financial support, together with elaborated technical assistance focused on strengthening the implementation capacities of government institutions, would streamline the path of transition of Ukraine.

The intention of the Ukrainian authorities to rely in the first instance on national resources, as stressed by Mr. Havrylyshyn, deserves all due respect. However, my authorities believe that Russia can contribute substantially to the reform process in the countries of the former Soviet Union, and that it can complement in this way the efforts of the rest of the donor community. My authorities are open to providing further financial support to Ukraine, together with other donor countries, and based on appropriate conditionalities.

Addressing the problem in general, my authorities believe that one of the most beneficial ways of providing financial assistance to the countries of the former Soviet Union could be by creating a special fund, under the supervision of the Fund, aimed at providing additional financial support for dealing with the problems that were caused mainly by the disintegration of the large economies, as was the case with the former Soviet Union and some other countries. Russia is ready to contribute $1 billion to such a fund. We believe that this idea deserves credit, and in case it comes to fruition, Ukraine could become one of the first potential beneficiaries.

I sincerely hope that the current Article IV consultation will be useful to the authorities of Ukraine in their attempts to design and implement a comprehensive stabilization program for the current year. I am convinced that, 12 months from now, we will discuss visible progress in the country's financial and structural situation. We convey our full support to the Ukrainian authorities in their challenging efforts.

Mr. Prader made the following statement:

At the time of the pre-membership economic review of Ukraine, this chair pointed to three concerns that might cloud the prospect of economic reform in Ukraine: first, the vulnerability of the Ukrainian economy to the disintegration of trade relationships within the former U.S.S.R.; second, the uncoordinated nature of macroeconomic policy management; and third, the lack of a political consensus about a wide-ranging economic reform program. It is regrettable, as I have learned from the staff report, that all three concerns have proven valid. The contraction in trade in the former Soviet Union indeed reflected more than just general economic disorder; trade suffered severely from a breakdown of the interstate payments mechanism in general, and from tensions in the relationship with the Russian Federation in particular. The uncoordinated nature of macroeconomic policy management was exacerbated by what the staff calls "raids by powerful lobbies on the

Treasury and the National Bank"; it is reflected, inter alia, in the supplement to the staff report, in which mention is made of the recent signals on monetary policy continuing to present a mixed picture. The political consensus about the reform program can be expected to materialize--at best--after the upcoming September referendum. It is to be hoped that our comments and recommendations will be heeded after this additional period of delay and uncertainty.

The assessment in the staff report that economic policy in 1992 tended to be reactive in Ukraine seems a considerable understatement in the circumstances. Contrary to what happened in neighboring new countries, where economic policy in 1992 could indeed be qualified as having reacted to emerging developments and problems--but at least in a more or less consistent way--the Ukrainian authorities seem to have displayed little success in forming a coordinated set of policy responses. Given the unclear division of responsibilities between Government, the President, and the Parliament, it was perhaps unrealistic to expect otherwise.

It was most unfortunate, however, that this uncoordinated approach has led to what could be called an interactive process of complication and deterioration of the Ukrainian economy, which has made the conditions for a starting point for a meaningful program of economic reform even worse. Indeed, as a result of piecemeal and ill-focused reform efforts, the production and export capacity of the Ukrainian economy was put at an even greater disadvantage than would have been the case otherwise. For example, Ukraine's well-known--even renowned--comparative advantage in agriculture was squandered, first by a policy of half-baked price liberalization, which imposed a severe internal terms of trade deterioration on the agricultural sector vis-à-vis the industrial sector, and then by a very slow process of transfer of land to the private sector. With respect to coal--another of Ukraine's natural endowments--the combination of a policy of passing on in full to industrial consumers the rising cost of imported energy, on the one hand, while maintaining administered prices and rising subsidies for domestically produced coal, on the other hand, has distorted consumption patterns, is keeping up the high energy intensity of production in Ukraine, and hence, has had an important bearing on the country's export capacity. Regarding exports in general, the combination of a relatively liberal import regime and a complex array of export control instruments is again blatantly disadvantaging domestic production. It is most welcome news that at least a partial liberalization of the export regime has been implemented on May 20, 1993.

In sum, the Ukrainian authorities urgently need, first, to devise a wide-ranging and effective strategy of market-oriented reform that will yield favorable supply-side responses, and second, to ensure the effective implementation of such a strategy. It is important in this regard not to confuse the need to re-exert state control over the economy with the need to re-exert policy management of the economy. To cite again an example: the need to bring down inflation calls most evidently for tighter fiscal and credit policies, but some intervention in the wage and price formation process may be useful. However, such intervention must clearly be embedded--without compromise or ambiguity--in a general strategy of freeing markets. As things stand now, the Ukrainian authorities are sending confusing signals about their price and wage policy stance, installing new price controls in some areas--such as trade--while rolling them back in others, such as agriculture. The equally urgent need for structural policy reforms will require moving from the planning to the implementation stage in a number of areas, ranging from the dismantling of the state orders system, to enterprise reform, to the privatization of the productive sectors of the economy. Again, there is a clear role for government here--to complement market forces by ensuring a level playing field for all economic agents and sectors. Thus far, the Government seems to have displayed only an inclination to substitute for market forces instead of complementing them.

With the growing indications of a major balance of payments crisis on the horizon, what can the authorities do, pending the outcome of the September referendum? Trying to hold the line in the budget and credit policy areas is definitely a first prerequisite: the budget position for the first four months of the year was thus welcome news, but the prospect of a renewed escalation of subsidies is looming. Preparing for the implementation of a more forceful exercise of macroeconomic damage control, while laying the basis for an acceleration in the pace of broad-ranging structural reform, seems to be the only other option available in current circumstances. The role of the Fund in this kind of environment is evidently reduced, but this should not be an excuse for doing nothing. The World Bank has recently approved an institution-building project for Ukraine. One of the components of the systemic transformation facility is to try and prepare the institutional framework of a country for a traditional program of macroeconomic stabilization and structural reform. Hence, discussions on a possible program under the systemic transformation facility should not necessarily come to a halt during the summer. Perhaps the staff could indicate how it envisages the design of a program under the systemic transformation facility for Ukraine, and what kind of actions the Ukrainian authorities would have to take as a minimum requirement. The authorities are also well advised to make good use of the technical assistance provided--or planned--by the Fund and other multilateral or bilateral organizations. Finally, all efforts to improve the economic data collection process will prove highly useful: they will allow for the proper assessment of the effects of certain policy decisions, as well as the correct description of economic circumstances on which to build appropriate policies.

If such preparatory work is undertaken now, Ukraine will be in a better position to undertake a decisive and full-fledged market-oriented reform program after the September referendum, a program that will bring prosperity to this important and potentially very rich country.

Mr. Schoenberg made the following statement:

Actual economic events in Ukraine in 1992 and early 1993 seem to confirm the concerns of Directors that were expressed at the pre-membership review in April 1992. At that time, the authorities were urged to implement measures to stabilize the financial situation, lift price controls, quicken the pace of privatization, and abstain from managing foreign trade.

As a consequence of widespread policy drift, however, inflation has accelerated to a level higher than in neighboring states, real GDP has continued to decline rapidly, external trade fell sharply, and price liberalization has progressed only slowly, leaving Ukraine in a comparatively early stage of the transition process relative to other countries undergoing reform.

Under these conditions, it is no surprise that the staff's policy recommendations read like a blueprint for basic economic reforms in formerly centrally administered countries. There is therefore no need for me to stress that I fully support the essence of the staff's recommendations as summarized in the staff appraisal.

The staff report could be interpreted--and the staff might wish to comment on whether this is a fair interpretation--in such a way as to suggest that, under the conditions prevailing in Ukraine, it might not be fruitful for the Board to engage in detailed discussions on individual policy aspects, as long as fundamental decisions as to the basic direction of the reform process, the desirability of moving in a determined way toward a market economy, and the role of the key institutions in that process, have not been taken, or as long as such decisions are not supported by important segments of the society or the authorities.

If we compare the scope and the urgency of economic policy reforms arising from the staff assessment with the policy actions actually being taken by the Ukrainian authorities, it is difficult for us to recognize the beginning of a consistent and sweeping reform process, whether gradual or of the shock approach, or something else. In particular, we cannot see even the initial stages of implementation of a serious stabilization effort. Part of the explanation for the deplorable lack of progress is, of course, the complicated domestic policy situation, characterized by an ongoing dispute between the Government, the President, and Parliament over their respective areas of responsibilities, and the massive frictional losses resulting from such disputes for economic policymaking. Under these conditions, why the staff is optimistic that Ukraine could still--this year--adopt a comprehensive program that would meet the requirements for a stand-by arrangement is difficult to comprehend.

I agree with the staff that the most critical macroeconomic tasks for Ukraine are, first, to bring down the rate of inflation, and second, to avert a looming balance of payments crisis. However, as the staff points out, the objective of macroeconomic stabilization is ineluctably linked to progress in building effective governmental and administrative structures. In Ukraine, the transformation from the high-cost institutional setting that prevailed under socialism to a low-cost institutional setting representative of a market economy seems to be an even more painful process than in other countries of the former Soviet Union. The staff highlights some instructive examples in the area of monetary policy, privatization, and price liberalization, which illustrate how the inadequate delineation of economic policy responsibility and the poor institutional setting impede economic management.

That being said, I would agree with Mr. Havrylyshyn that a major reason for the mixed results has been the serious institutional hindrances to the effective implementation of the reform efforts that have been undertaken. This is certainly true if the fact is taken into account that the economic shocks that resulted from the disintegration of the former Soviet Union posed objectively--as the staff points out--extraordinary difficulties for policymakers. However, like Messrs. Prader and--I think--Kagalovsky, I have the impression that the unclear division of responsibilities--not only between the Government, the President, and Parliament, but also between central and local governments, between individual ministries, and between Parliament and the National Bank of Ukraine--also impedes consensus building, undermines the chance to implement mutually reinforcing policies, and blurs the general thrust of the reform effort.

Regarding monetary policy, the staff has left no doubt about the consequences of a failure to reign in inflation: rising inflationary expectations would precipitate an accelerated flight from money, would further reduce, by way of an ongoing deterioration of the terms of trade, output and employment, and would thereby lead to a further pauperization of the population. This prospect puts into perspective the overriding importance of monetary stabilization compared with, inter alia, any improvement, streamlining, or better targeting of the social safety net. Readers of the chapter in the background paper on recent economic developments on the introduction of the coupons in Ukraine will be reminded of Gresham's Law that "bad money drives out good"--although it might be difficult to determine the good money in this case.

I fully support the staff's institutional and procedural recommendations for tightening monetary policy, stressing my belief that, without institutional reform, the National Bank of Ukraine could not really begin to focus on the primary functions of a central bank, and the stabilization effort would probably not succeed. I note in this respect--with some relief--that Parliament approved the NBU's monetary program for the remainder of 1993.

The need for a comprehensive institutional reform is also prevalent in the fiscal domain. This relates to the necessary reforms of the tax system, the strengthening of cash management, the need to establish a treasury function, and the reduction of subsidies and social security outlays. According to World Bank estimates, total public social spending in 1992 amounted to 44 percent of GDP, an extremely high ratio by international standards, in particular if seen against the depressed resource base in Ukraine. Emphasis should be put on the improvement of the incentive structure, in particular on strengthening incentives to work.

I take it from the supplement to the staff report that the budget showed an unexpected strengthening during the first four months of 1993, but that it is expected to deteriorate again, with a projected increase in subsidies, wages, and pensions. In order to reach the targeted budget deficit of about 6 percent of GDP this year, further expenditure cuts--above all, in subsidies--over and above those anticipated so far, could become necessary, especially if the authorities should come to share the staff's concern about the plausibility of the revenue estimates.

The staff's statement that "little of the decline in economic activity can be ascribed to the effects of positive restructuring" is quite instructive. Among the major factors responsible, the staff identifies the severe disruptions in Ukraine's traditional trade and payments arrangements and, in particular, the breakdown in the interstate payments mechanism. The decline in output in all the states of the former Soviet Union was, indeed, self-imposed, to the extent that there has been widespread resistance in the past by almost all parties to setting up a payments union--at least as a temporary mechanism--which could have prevented at least that part of the contraction in trade that resulted purely from technical factors. The argument--also put forward by Western analysts--that a payments union would only have cemented existing centrally imposed trade structures and hindered a swift transition toward global trade integration has never convinced me. The existing trade and production structures in the former Soviet Union were a reality that could not have been changed in the short run in any case. The alternative, as it turned out, was little global integration, but--above all--export quotas, import barriers, licensing requirements, and barter trade. Thus, the inevitable costs, in terms of production losses, involved in the transition process were raised tremendously by the collapse of intra-regional trade, which could have been prevented, at least in part. It is probably too late now to establish a payments union, as the damage has been done. The critical balance of payments situation in Ukraine therefore leaves no alternative other than a rapid dismantling of the anti-export bias of the trade regime, and the continued liberalization of the import regime and foreign exchange markets. I also agree with the staff that, in view of the critical importance of Ukraine's trade with the Russian Federation, a clarification of the financial and credit relationship--at the least--between these two countries is most desirable.

It appears that the aspirations of the Ukrainian people, put so well by Mr. Havrylyshyn, will best be served at this juncture by an unwavering political commitment to a coherent reform strategy. Such a commitment counts most, as it will catalyze international support, both financial and technical, thereby helping to overcome the enormous difficulties of implementing reform measures. The most recent measures taken by the Ukrainian authorities, as described in the supplement to the staff report and by Mr. Havrylyshyn, will tend to strengthen international confidence in the reform process. Putting in place quickly measures that would enable Ukraine to qualify for assistance under the systemic transformation facility would be another major step in that direction.

Mr. Kagalovsky commented that he had not spoken about a payments union, which had not been a viable idea one from the very beginning. A balance of payments crisis confronted all the states of the former Soviet Union, including Ukraine, as a result of the disintegration of the old Soviet trading area. For that reason, the balance of payments problems of all the countries of the former Soviet Union were similar. Therefore, he put forward an idea of a special fund within the International Monetary Fund, that could be established to alleviate some of those balance of payments pressures. Such a fund would also help to ensure that the problems of the former Yugoslavia did not occur in the former Soviet Union as well. His Russian authorities were willing to consider contributing $1 billion to such a fund.

Mr. Dawson made the following statement:

Ukraine lacks a coherent economic strategy. The Government has sought to stabilize both output and prices--an effort doomed to failure under current circumstances. When it became independent almost two years ago, Ukraine inherited industries and economic structures that reflected years of isolation from international markets. The breakup of the Soviet Union and quest for free markets made the decline of these old Soviet industries inevitable, as cheap inputs disappeared and former trade ties dissolved. Active policies to restructure these industries and encourage new business entrants are necessary if the inevitable decline in output is to be offset by new producers and production.

Ukraine's current high inflation environment is the result of misguided policies designed to slow the decline in old Soviet industries through controlled prices, cheap credits, and minimal structural reform. Despite its best efforts, decline was not slowed appreciably. Unfortunately, the macroeconomic destabilization caused by these policies has created a cascade of economic distortions that have discouraged new economic entrants and prolonged the inevitable transition period of economic adjustment.

Fund staff has correctly identified the country's high inflation and balance of payments weakness as the most immediate problems facing Ukraine. Many of the country's economic distortions emanate from the lack of price liberalization, artificially low interest rates, and continued direct government control of the economy. These factors generate pressure for subsidies and budget deficits, allow easy money policies, and encourage an obtrusive trade regime; all of which engender high inflation and balance of payments pressure. Reasserting strong leadership over economic reform policies, gaining control of the National Bank, and consistently implementing agreed goals are important steps that the Government must undertake to begin stabilization.

Ukraine's GDP shrank by 14 percent in 1992, and has fallen by 28 percent since 1989. Unfortunately, little of this decline has been due to economic restructuring. The Government's first priority continues to be short-term output stabilization, which has left Ukraine more vulnerable to further import shocks and prolonged economic decline.

The Ukrainian Government continues to have a very direct role in the economy, allocating energy and productive inputs in many sectors of the economy, especially agriculture and exportable goods. While some progress has been made in structural reform, monopolistic state firms are still dominant. Reducing overall government control must be an immediate step in Ukraine's reform program.

Inflation has approached hyperinflationary levels, staying at about 30 percent per month in the fourth quarter of 1992 before rising still further in the first quarter of 1993, increasing 227 percent, although much of this was due to increases in administered prices.

While the Government's new reform program freed some prices, it actually increased the overall level of price regulation. For example, agriculture prices were liberalized, but profit margins were maintained and state control of inputs continued. Price controls required many other forms of state intervention as well. Price controls on tradable goods also caused the Government to increase its control over exports in order to capture subsidy rents. One significant bright spot is the Government's decision to pass through all of the energy price increases to industrial users; this policy should be extended to consumers as well, in order to discourage wasteful consumption.

Price reform is the first and most basic market reform. All prices, especially exportable products and energy, should be liberalized without delay as a first step in significantly reducing the amount of government control in the economy.

Ukraine ran an extremely large budget deficit in 1992, equaling about 28 percent of GDP, primarily owing to lower than projected collections of the new value-added tax and profits tax. Expenditures equalled about 61 percent of GDP--a proportion that is inconsistent with building a market economy. Lowering expenditures and reducing the Government's role in the economy should be emphasized in reducing the deficit, which is indispensable for stabilization.

The Government's stop-gap measures for controlling spending in the first quarter of 1993, such as using taxes to restrict wage increases, are commendable, and should be maintained. Keeping the minimum wage down is especially important because many other benefits and wages are tied to it. The 1993 budget deficit goal of 6.2 percent is respectable, and if achieved, would be an important step toward stabilization. As the Fund has pointed out, however, the Government's revenue and macroeconomic assumptions are unrealistic. To meet this target, the Government needs to liberalize prices significantly, to reduce subsidies, and to implement very limited and targeted transfers to vulnerable population groups. Industrial subsidies, which were 25 percent of GDP in 1992, should be significantly reduced, and subsidized credits to state firms eliminated. As the staff report notes, at the actual budget implementation level, improved cash management is the key to meeting the Government's deficit goals, which will improve decision makers' ability to resist interest group pressure.

Monetary policy in Ukraine is passive and extremely weak. Regaining control of the money supply is an essential component of any effective stabilization effort. Money supply increased at 25 percent per month during the second half of 1992, spiking to 50 percent in December, before resuming its 25-30 percent growth in the first quarter of 1993. In 1992, money supply increased twice as fast as that in the Russian Federation and Belarus, and its currency, the karbovanets, has been in a free fall against both the dollar and the ruble.

The country completely lacks a quantitative credit policy. While the budget was in balance during the first quarter of 1993, and real wages fell by 50 percent, credit continued to explode. Part of this was due to 1992 interenterprise arrears and planting needs in the agricultural sector, but most was simply a result of easy credit availability at rates even lower than the highly negative NBU refinance rate.

The National Bank's plans to increase the refinance rate--as it has already begun to do--to limit access to refinance credit, and to put explicit ceilings on commercial bank credit would, if allowed by the Parliament, be very important steps to regaining monetary control. In addition to these laudable plans, stricter reserve requirements and an end to all subsidized credits are needed in order to make credit restrictions effective. Several institutional reforms will probably also be necessary, including giving the NBU complete authority and responsibility for the credit program, unhindered by the Parliament and political pressures. Limitations on credit and increases in the interest rate are important for reducing the excessive liquidity in the economy, reducing inflation, and shoring up the value of the karbovanets.

As the staff has noted, statistics for balance of payments are very weak. However, it is telling that the country's $500 million current account surplus with countries outside the former Soviet Union did not result in a corresponding change in the capital account or an increase in convertible currency reserves. The country's external accounts is the area in which the distorting effects of the Government's economic policies are most apparent. Most fundamentally, nonmarket prices, related export controls, and easy credit policies discourage exports, increase the consumption of scarce imported energy, and encourage capital flight, thereby increasing the pressure on the country's already weak balance of payments. The Government's macroeconomic policies further exacerbate the problem by creating a destabilized environment which discourages productive investment and does not qualify for external support from the international financial institutions.

As noted earlier, macroeconomic stabilization, reducing the role of government in the economy, and structural reform are important for addressing these problems. The Government's low import tariffs and unified exchange rate will help control the price discretionary power of state firms. Steps already undertaken to transfer hard currency holdings to the NBU and establish correspondent accounts with Russian commercial banks are also moves in the right direction. Further changes are needed to eliminate the hard currency tax on export revenues, which discourages exports and foreign exchange repatriation.

The country's overwhelming proportion of large state-owned firms in the economy, most with price discretionary power, is a significant impediment to stabilization and structural reform. Privatization laws have been passed regarding small firms, agriculture and housing. However, except for some pilot small firm auctions, privatization has not begun in earnest, owing to conflicting laws and the lack of strong administrative structures and leadership to push the process. The lack of improvement in state firm governance, continued subsidized credits, and obstacles to new firm entry have further discouraged structural reform.

Increasing competition and reducing state firm pressure on the budget require significant structural reform. The Government needs an internally consistent and simple privatization program, with strong leadership and competent, committed administration. The Government must also reduce its role in the economy by eliminating state orders, strengthening its governance of state firms, and accelerating corporatization. Small- and medium-sized firm auctions should be expedited and expanded from their present "pilot project" status.

Mr. Lanciotti made the following statement:

In 1992, the unavoidable adverse consequences of the breakdown of the interrepublican trade and payments system were exacerbated in Ukraine by the lack of a clear and consistent program of economic stabilization and structural reforms. Prices were partially liberalized in January 1992, but profit limits and regulatory constraints prevented the formation of a price structure reflecting the relative scarcity of goods. The role played by the state in the economy remained pervasive through the centralized control over the allocation of productive inputs, the system of state orders, the imposition of export restrictions, and the availability of budget and credit subsidies. The lack of enterprises' financial discipline hampered the restructuring process, provoked the buildup of interenterprise arrears, and supported a dynamic of real wages inconsistent with the ongoing decline in output and labor productivity. These developments resulted in an unsustainable widening of the budget deficit and in a loss of monetary control, which boosted inflation, fostered capital flight, worsened Ukraine's external position, and undermined the credibility of the recently introduced national currency. The credibility of the whole market-oriented reform process has been put in jeopardy.

In order to avoid a further deepening of the economic crisis and of the resulting social unrest, it has become extremely urgent for the Ukrainian authorities to embark on a bold and sweeping stabilization program along the lines suggested by the staff.

Despite the fall in economic activity, registered unemployment has remained modest as a consequence of the absence of enterprises' financial discipline. The likely increase in unemployment in the coming months might be the result of two different scenarios. On the one hand, unemployment might be caused by the collapse of economic activity as a consequence of the hyperinflation process that the current stance of financial policies is breeding; on the other hand, it might be the result of a tightening of financial policies that will result in the bankruptcy of many unprofitable enterprises. This second alternative will create the appropriate macroeconomic environment for the development of new business activities and, hence, of job opportunities; it is therefore the only viable avenue to follow. Reducing inflation and stabilizing the external value of the national currency should be at the top of the new economic agenda. The authorities must therefore regain a firm grip on budgetary and monetary developments, strengthen financial control over state-owned enterprises, and bring wage dynamics back on a path consistent with the stabilization efforts, thus promoting an economic environment conducive to a recovery of investment activity.

As clearly emphasized by Mr. Havrylyshyn, the new Government is moving in that direction, and for that it deserves our support, even though the road ahead is still long and difficult. I will focus on some of these difficulties.

Regarding fiscal policy, the high degree of uncertainty surrounding revenue developments and the potential additional pressures on unemployment benefits call for a tight monitoring of budget outlays, with particular emphasis on a rapid phasing-out of producer subsidies, in order to harden enterprises' budget constraints. A reform of the social safety net is also needed, in order to make it more cost effective and better targeted to the neediest part of the population. In these circumstances, the restructuring and broadening of the tax system, the improvement of its administration, and the setting up of efficient budget institutions are not less crucial elements of the policy of fiscal consolidation. Furthermore, a clear definition of functions assigned to the central and local governments, and of the corresponding criteria governing revenue and expenditure sharing among them, is necessary, in order to avoid the emergence of potential conflicts between different levels of government that could exacerbate the difficulties of bringing the budget deficit to the desired path.

One of the most urgent tasks of the Ukrainian authorities in the process of macroeconomic stabilization is to impose monetary discipline. So far, as in a typical command economy, monetary policy has played a passive role. The allocation of credit through administrative mechanisms and at subsidized interest rates has aggravated the burden of nonperforming loans on the banks' balance sheets, and has prevented the imposition of financial discipline on the enterprise sector. The lack of independence of the central bank from the Parliament, the mixing of the monetary and fiscal domains that stems from the practice of allocating credit to the economy at subsidized interest rates, and, more generally, the persistent strong links between government, banks, and state enterprises, hampered the pursuit of a firm credit policy conducive to reducing inflation. These obstacles should be removed in order to gain control over monetary developments, to promote the development of competitive financial markets, and to allow interest rates to play an allocative role. I am therefore puzzled by the recent developments in the monetary area reported by the staff in the additional informative note, in which the encouraging progress regarding the approval by the Parliament of the monetary program of the National Bank of Ukraine and the increase in the interest rate on nondirected refinancing credit is offset by the persistent involvement of the National Bank in the allocation of direct credits. By giving these conflicting signals to the economy, the Government aggravates the uncertainties that still surround the reform process.

In order to curb inflationary pressures, fiscal and monetary policies should be supported by an appropriate incomes policy. Bringing real wages to a level more consistent with the large output and productivity drop experienced so far is a crucial component of the stabilization strategy. In this context, I believe that any potential mechanism for controlling wage growth should fulfill two fundamental conditions. First, it should avoid a compression of wage differentials, in order to maintain workers' incentives and to avoid a process of wage catch-up. Second, it should partially link wage growth to the expected path of inflation, with few adjustments within a year, in order to eliminate inflationary inertia. I have therefore some concerns about the present mechanism that links the maximum--tax-free--level of wages to a given percentage of the level of wages in 1990. As the recent experience has shown, this mechanism seems to give rise to sharp oscillations in real wages, pushing the authorities to adjust the coefficient between the two wage levels, thus perpetuating inflationary pressures and introducing more uncertainty into the economic system. Further comments by the staff on this issue would be appreciated.

In any event, if the stabilization effort is to be sustained, discipline must be imposed not only at the macroeconomic level, but also at the microeconomic level. Restructuring the enterprise sector, promoting privatization, improving the payments system, and enforcing the bankruptcy law are all relevant elements on which the Ukrainian authorities have to strengthen their efforts.

I welcome the recent measures to partially liberalize the export regime as a promising step in the direction of reducing distortions in the economic structure. I also welcome the debt agreement between Ukraine and the Russian Federation, which could pave the way to a more stable and fruitful collaboration between these two states.

I support the draft decision.

Mrs. Martel made the following statement:

A year ago, at the time of the pre-membership review, many Directors pointed out that the Ukrainian authorities, like the authorities of other republics of the former Soviet Union, were faced with great challenges which they had to meet under difficult and rapidly changing circumstances. The Ukrainian economy was affected in 1992 by severe external shocks, including major disruptions in trade and payments arrangements and the effects of the GNP decline in other countries of the former Soviet Union.

At that same meeting, the importance of taking significant measures to stabilize the macroeconomic situation and pursue the restructuring of the economy toward a market-based system was also highlighted. The authorities also distributed a program of economic reform that emphasized fiscal and monetary prudence so as to achieve stabilization, market-based structural adjustment, and targeted assistance to the neediest.

As it turns out, even though the difficult external environment must be taken into account, economic performance in 1992 was disappointing, especially as regards progress toward stabilization. The state budget deficit reached 32 percent of GDP compared with a budgeted deficit of 2 percent of GDP. Financing of the deficit by the banking system and the provision of large amounts of credit to enterprises contributed to a monthly increase in broad money of more than 20 percent, and, in turn, to the high rate of inflation. Moreover, the loose fiscal and monetary policies did not prevent an important fall in real GDP, which was spread among almost all sectors.

A number of important steps were taken as regards structural reforms, such as enactment of legislation on private property, bankruptcy, foreign investment, privatization, liberalization of exchange arrangements, and further liberalization of some retail prices. However, the staff report clearly indicates that state control over the economy remained extensive, with a still large degree of government control of price formation, a sizable system of state orders, no formal privatization of medium- or large-scale enterprises in 1992, and slow transfer of land and residential property to private hands. The high degree of involvement of the state in the economy was also reflected in the amount of general government expenditures, which reached 75 percent of GDP. Moreover, state enterprises appeared to have little incentive to restructure their activities in the absence of a hard budget constraint.

Given this situation, and in view of the significant risk that the Ukrainian economy could be subjected to additional shocks--especially terms-of-trade shocks--I fully share the thrust of the staff appraisal. Credit and budget policies must be tightened significantly, and appropriate mechanisms ought to be put in place to ensure that the public deficit and credit creation targets will be met effectively. At the same time, restructuring and privatization of the enterprise sector, land and housing privatization, and price liberalization must be accelerated, not only to stimulate the supply of desired goods, but also to reduce pressures on fiscal and monetary policies. The implementation of a better-targeted social safety net should complement these measures, in order to mitigate the impact of the necessary program of stabilization and restructuring on the most vulnerable segments of the population.

With respect to price liberalization, I note the concern of the authorities about monopolistic pricing. This concern may well be justified in a few areas, and may lead the authorities to establish mechanisms to control prices of a small number of goods or services. This would correspond to what is done in many countries for the products of so-called natural monopolies.

However, a vast array of arguments points to the importance of allowing prices to be market determined. The staff appraisal presents a number of the costs of pervasive price controls, such as the misalignment of relative prices, the creation of the need for large subsidies, and the negative impact on the balance of payments. Also, the costs imposed by a system of ad hoc price controls are increased in a context of high inflation, as the dangers of serious relative price misalignments are multiplied, and a high level of uncertainty about the evolution of input and output prices hinders the adoption of efficient production decisions.

Furthermore, it would appear that, in theory, the Anti-Monopoly Committee, set up by the Anti-Monopoly law, has sufficient power to deal with monopoly abuses. Making the Committee fully operational would seem to be the proper way to deal with monopolistic excesses, while prices could be freed to let them play their allocative role. While additional price liberalization could create a one-time increase in the general price level, such a liberalization, when coupled with a proper tightening of fiscal and monetary policies, would result in a lower rate of inflation. This outcome could only be viewed favorably by most economic agents.

With respect to fiscal policy, the budget deficit target of 6 percent of GDP is commendable. However, the reduction in the budget deficit is to be achieved through a very large increase in the ratio of revenues to GDP, while the ratio of expenditures to GDP is expected to increase by more than 10 percent. Furthermore, there seems to be reasonable doubt as to the plausibility of the expected level of revenues and, consequently, as to the possibility of achieving the budget deficit target.

In any case, the experience of 1992--when actual revenues fell short of expected revenues by more than 14 percent of GDP--should in itself be grounds for caution in fiscal matters. It points to the high level of uncertainty regarding revenues and expenditures in an economic environment marked by high nominal and real volatility. Therefore, I agree with the staff that a strong mechanism for cash management, with a specific link between monthly revenues and monthly expenditures, will be essential if the task of fiscal consolidation is to be achieved.

A tightening of monetary policy hinges upon the possibility of limiting the extension of credit to both the Government and enterprises. Limiting credit extended to the Government obviously depends, in the absence so far of bond financing, on progress being made on fiscal consolidation. Limiting the provision of credit to enterprises, just as obviously, will require a drastic change in the functioning of the National Bank.

The experience of 1992, in Ukraine as in other countries, shows that an appropriate degree of control over monetary aggregates by the central bank cannot be achieved if that same central bank is responsible--either willingly or unwillingly--for providing large amounts of ad hoc directed credits to preferred sectors of the economy. Therefore, as the staff indicates, it is essential to implement a quantified credit program consistent with a marked reduction of inflation, and to impose a subceiling on all directed credits within the framework of the credit program, with a view to progressively eliminating such credits and gradually raising the refinance rate to a positive real level. Furthermore, given that the financial position of commercial banks is most probably quite fragile, close control of their activities is necessary. In this respect, in the present circumstances, a uniform ceiling on the growth of lending by each bank seems appropriate.

Some progress has been made on privatization, and it is noteworthy that the first formal privatization of a medium-scale firm was implemented early in 1993. Nevertheless, overall, developments on this front appear to be slow in coming. Furthermore, there seems to be some legal ambiguities about so-called "spontaneous" small- and medium-scale privatization.

Significant constraints on the ownership of agricultural land in particular remain, and a market for commercial land and buildings has not yet developed. These represent important obstacles to the development of Ukraine's private industrial and commercial sector, as well as impediments to the exploitation of Ukraine's very real agricultural potential. It would therefore appear that determined actions in this area have the potential to generate important positive supply-side responses.

I note with pleasure the extensive technical assistance provided by the staff to Ukraine, and I encourage the staff to continue this important and valuable work. This institution's continuous support of the authorities' efforts is essential, and the authorities' progress toward implementation of a comprehensive program of stabilization and reform should trigger additional support.

Mr. Kanada made the following statement:

I am in broad agreement with the thrust of the staff's appraisal. The Ukrainian authorities recently embarked upon an economic reform policy leading to a market-oriented economy. As part of this policy, they also withdrew from the ruble area and introduced a new currency, the karbovanets. Thus, the foundation is being formed on which an independent monetary policy can be pursued under a new currency.

Unfortunately, however, the economic situation has deteriorated considerably since the pre-membership review last April. Regrettably, this is due mainly to the lack of political consensus in the Government for reform that would lead to a market-based economy. Reflecting this, the Government has intervened in many areas, and various controls have been maintained.

Also, tight fiscal and monetary policies, as well as structural policy, cannot be pursued efficiently because the government agencies are not functioning. Since these policies are important in reducing inflation--the most serious problem facing Ukraine--an organizational mechanism should be constructed as soon as possible to implement the various policies.

It is therefore very important at this stage that the authorities reconfirm their political commitment to economic reform and try to redress the distortions caused by the current political interventions. In light of these unfavorable conditions, I welcome Mr. Havrylyshyn's statement, in which he confirms the authorities' commitment to an economic reform policy.

With respect to fiscal policy, it is urgent for the authorities to reduce the government deficit, which is approximately 30 percent of GDP. On the expenditure side, it is estimated that expenditure will even increase--from 45.5 percent of GDP in 1992 to 57.5 percent of GDP in 1993--in spite of the critical situation. This is contrary to financial stability. A tight fiscal policy, especially measures to curtail expenditure, including the elimination of subsidies and a prudent wage policy, needs to be pursued more vigorously in order to reduce the government deficit, as well as the inflation rate.

I agree with the formulation of a mechanism to control expenditure, which is the first prerequisite for meaningful budgetary control. It should be implemented as soon as possible.

On the revenue side, it is doubtful whether the estimated increase in revenue in 1993 will be attained, in light of the experience in 1992. If the estimated revenue for 1993 is not attained, the government deficit is expected to widen even further. I would appreciate it if the staff could comment on what additional revenues measures could be taken.

With respect to the implementation of monetary policy, it is a matter of great concern that the central bank is still not functioning as a proper monetary institution, but continues to be under the considerable and substantial influence of Parliament. A rigid mechanism should be established in which the central bank has full responsibility for the conduct of monetary policy.

In this connection, although it is welcome that the central bank has prepared a qualified monetary program, including a quantified financial policy target, with the intention of reducing the inflation rate, unfortunately the program was not endorsed in its entirety by Parliament. However, it is important that Ukraine put into practice at least whatever is possible.

Concerning structural policy, in light of the economic distortions caused by subsidies, all subsidies should be considered within the budget and should be provided only in a limited way, and only if indispensable. At the same time, the authorities should prepare a timetable to phase them out by implementing price liberalization.

Regarding privatization, although it is welcome that work on establishing a legal framework is proceeding, it is far from the implementation stage. Much remains to be done, including the formulation of a detailed plan of action.

On the external front, as pointed out in the staff report, statistics on the balance of payments have not been reliable. The Fund is expected to play a more active role in the improvement of Ukraine's statistics, which are quite important in considering external measures.

More has to be done on the trade issue, especially in the export sector, through deregulation and liberalization, taking account of the present complicated export regime.

I recall that last year, I pointed out Ukraine's potential, and I encouraged the authorities to carry out reforms toward a market-oriented economy. Unfortunately, the performance was contrary to our expectations. We agree with Mr. Havrylyshyn that most of 1992 was a year of policy drift and of lost opportunity for economic reform. Indeed, the new currency has not brought any benefits, as it was not backed by the proper fiscal and monetary policies. It is therefore heartening to learn in the same statement that the authorities have reconfirmed their commitment to meaningful stabilization and reform.

We strongly hope that a firm and sincere commitment to tight fiscal and monetary policies, as recommended by the staff, and the fulfillment of this commitment, will lead to the next stage, which is to discuss the systemic transformation facility in the context of Ukraine.

The staff representative from the European II Department stated that the staff stood ready to resume discussions on a possible program under the systemic transformation facility for Ukraine when there was greater clarity and stability regarding the authority and responsibility for economic policy in Ukraine. The staff remained in continuous contact with the authorities on the matter, and the situation had been changing very rapidly. The main element of such a program would be, as Mr. Schoenberg had said, restoring financial stability. The staff appraisal had been written deliberately in a prescriptive form, looking toward a financial operation, and it went into more detail in some areas than had been typical in some other countries, especially regarding the mechanisms for establishing monetary control and strengthening fiscal control. Actions in those areas would be important evidence that the financial situation was being brought under control.

The staff's statement that a stand-by arrangement for Ukraine could be in place before the end of 1993 was not meant as a forecast, but stemmed rather from an assessment of the external situation facing Ukraine, which suggested that, under any plausible external scenario for the country, a very large financing gap would exist, the staff representative explained. That gap could not be closed by use of the systemic transformation facility and by parallel assistance from the World Bank. Against that background, it seemed to the staff all the more imperative that Ukraine set its sights on moving quickly from an agreement under the systemic transformation facility toward a stand-by arrangement, with the former being a precursor of the latter.

The Parliament had approved the monetary program that had been submitted by the National Bank, the staff representative observed. The question was whether or not the monetary program would be respected by Parliament, as there had been reports of substantial credits being mandated by Parliament subsequent to its approval of the program.

The structure of wage policy made for rigidity and the need for abrupt changes in wages, which could be destabilizing, the staff representative noted. In that sense, there were similarities with the administration of price controls, with prices being held unchanged for a number of months before being raised sharply in the face of rapidly monitoring subsidies, with consequent large shocks to the economy. However, the modalities of the wage policy now being implemented needed to be judged against the background of the difficulty of forecasting inflation, and the authorities' desire to implement a policy that could be effective under the circumstances. Many of the administrative efforts to bring some order into wage growth had failed, whereas the most recent effort had clearly had some success, at least thus far.

Regarding the possibility of implementing additional revenue measures to close the fiscal gap, it needed to be borne in mind that tax rates in Ukraine were not low, and in fact, were arguably too high in some areas, the staff representative concluded. That reflected the fact that there were widespread exemptions from taxes, which were of the order of 30-40 percent for the profits tax and for the value-added tax. The authorities could do more to reduce exemptions and to apply those taxes more broadly. However, like most speakers, the staff would emphasize that the solution lay on the expenditure side; a surge in expenditures had caused the breakdown of the budget, and it was through the reduction and control of expenditures that strong public finances might be restored.

Mr. Shaalan made the following statement:

> The staff report clearly and rightly conveys a sense of urgency about Ukraine's mounting economic problems. While recognizing the difficulties that confront the authorities in the monumental task of transforming their economy to a market-oriented one, it is vital that they persist in their efforts with renewed

and more coordinated determination. There is no other viable option.

As the staff rightly notes, macroeconomic stabilization aimed at stemming inflation and inflation expectations, as well as the looming balance of payments crisis, must be the focus of the authorities' immediate efforts, and should be addressed without delay if the deteriorating economic and political situation is to be arrested. However, the ability of the authorities to deal decisively with these problems is predicated on a strengthening of the institutional framework and the development of clear lines of authority, as well as a centralization of responsibility for economic management. The importance of this cannot be overemphasized, since without effective decision-making and implementation powers, the Government's goal of financial discipline will prove once again to be elusive. The overall government deficit, amounting to some 28 percent of GDP in 1992, is but a reflection of the absence of an effectively centralized decision-making process.

Regarding fiscal policy for 1993, I agree with the staff that the revenue estimates from the value-added tax, foreign trade, and privatization appear unrealistic, and the deficit target of 6.2 percent of GDP too ambitious, unless the budgeted level of expenditure is curtailed further. The supplement to the staff report already indicates that the fiscal position has deteriorated significantly and that the attainment of the deficit target is even more improbable. While raising retail prices on a number of items on June 3, 1993 is a commendable step, I would urge the authorities to complement this by putting in place the targeted social safety net envisaged in the Government's policy as presented in the staff report. Such a social safety net is essential if the sustainability of the Government's subsidy cuts are to be maintained.

While certain positive actions have been taken with regard to monetary policy, the authorities continue to give mixed signals in this area. The rate of credit expansion still remains excessive. Even though certain measures have been taken to stem this expansion, the planned moratorium by the National Bank on new refinancing credits was delayed, and bank-specific credit ceilings have not been set. I would urge the authorities to take further steps to eliminate the automatic overdraft facility on banks' correspondent accounts at the National Bank, to set subceilings for the preferred sectors to which credit is allocated, and, finally, to redefine the National Bank's role as a true central bank rather than an allocator of credit.

I would like to raise a question here about the effectiveness of monetary policy given the problem of interenterprise arrears and measures to contain them. If recent trends in the fiscal and monetary areas continue, there is a real danger of a price-wage spiral that would be detrimental to any reform effort.

Regarding the imminent balance of payments problem that is facing Ukraine primarily as a result of the large increases in the price of imported energy, I would, like the staff, urge the authorities to implement forthrightly and with determination their stabilization policies, which would, in turn, enable Ukraine to qualify for assistance under the systemic transformation facility, thus avoiding further costly and, most likely, disorderly adjustment. The identification of energy-saving measures will also be important. Further measures on the freeing of exports will also need to be taken, although these will need to be coordinated with further price liberalization so as to avoid the outflow of subsidized products.

It was unfortunate that the staff discussions with the authorities on an arrangement under the systemic transformation facility were delayed. In view of the serious economic situation facing Ukraine, I hope that these discussions will commence in the near future.

Mr. Zhang made the following statement:

After its independence in August 1991, Ukraine made it clear very quickly that its objective was to transform the ailing economy into a market-based system. The authorities have implemented a series of reform and adjustment measures, such as price liberalization and adjustment, monetary reform and small-scale privatization, and passed a number of important laws.

Nevertheless, success so far is marginal. Like other states of the former Soviet Union, Ukraine remains severely handicapped by its runaway inflation and continuous sharp output contraction. In addition, the economy is still threatened by a number of potential crises in the energy sector and balance of payments area. Looking back at those measures taken so far and the evolving reform process, it seems certain that the difficulties during the transition to a market-based economy are greater than expected, or, to put it differently, that they have been underestimated. The authorities may still need to strike a balance between the pace of various reforms--for example, quickening the present slow reform in the agricultural sector and moderating the pace of price reform of consumer goods, which requires a more coordinated approach.

One of the difficulties lies in the fact that the bulk of Ukraine's current industrial structure is based upon the state-run heavy and military industries. It seems that most of these are the manufacturing, high energy consumption industries. Right now, one challenge facing the authorities is how to transform or adjust their structures. These industries, concentrating much skilled labor on advanced equipment, are currently short of input supply, especially energy, and most of their products are either not in demand or are uncompetitive. It is not an easy task to reorient production without sufficient financial resources, not to mention privatizing enterprises, which would cause a higher unemployment rate and jeopardize social stability.

In addition, the energy crisis continues to threaten the stability of the economy. At present, a big gap remains between Ukraine's demand for petroleum and its own supply. The sharp rise in petroleum prices--by several hundred percent--has already had adverse consequences on the price level and the balance of payments. The prospects for improvement are still uncertain.

Regarding some key policy issues, Ukraine is the first state among the countries of the former Soviet Union to introduce its own currency. This is entirely the sovereign decision of the authorities which should, in principle, enable them to implement an independent credit and monetary policy, consistent with the goal of fighting inflation. However, their experience has not been altogether positive, owing to various constraints, such as an unsettled institutional framework, lack of policy coordination, deficient legal support for the central bank in playing its legitimate role in combating inflation, as well as restraints arising from other delayed structural reforms. Therefore, it remains a formidable task for the authorities to exercise strict monetary discipline to control the expansionary growth of credit and money. The introduction of the new currency should not be seen as an easy way to supplement the deficient cash supply that existed at the time that Ukraine withdrew from the ruble area. In any event, monetary reform should be directed to facilitating a quicker stabilization process, which remains the first priority of any immediate efforts to turn the economy around.

Under the present financial system, in which all of the deficit has to be financed by the banking system, it cannot be overemphasized that sustainable fiscal consolidation is the key to any success in stabilizing the economy. The slow progress made in this regard is a matter of grave concern. It is true that the authorities do not have enough room for maneuver in the present circumstances, when the burden of running loss-making state-owned enterprises and subsidization of various sorts--such as price subsidies--remain as heavy or even heavier than before. Besides, the tax base is not likely to be broadened in the short run in the context of a continuous contraction of output, and in the absence of an early and comprehensive tax reform. That is why I am not optimistic about the short-term budgetary developments. In general, therefore, I agree that fiscal policy should focus mainly on expenditure cuts, although that is hard to do.

Equally important, structural reform in many areas--the trading system, the financial and enterprise sectors--needs to be strengthened substantially. To make it more coherent and expedient, the authorities need to acquire sufficient domestic support for their reforms. Since the new Government came to power, renewed efforts have been evident in pushing the reform process. Although uncertainties persist in the process, most of the Government's efforts seem to have been rightly directed toward adopting a pragmatic approach to reform, enhancing the capacity of the authorities to implement reform measures, as well as strengthening their capacity for indirect intervention. Of course, stabilizing the economy, improving the economic and trade relationships with Russia and other states of the former Soviet Union, and seeking the necessary assistance from the international community--including the Fund--also have to be placed on the agenda. The authorities are encouraged to follow along these lines and get ready to request assistance from the Fund.

I support the proposed decision.

Mr. Smee made the following statement:

Through much of 1992 and so far in 1993, political paralysis has thwarted attempts to implement comprehensive macroeconomic stabilization measures and systemic reforms in Ukraine. Political intransigence between the Government, Parliament, and the President over the nature of economic reforms has led to policy drift and economic instability.

The absence of a clear division of responsibilities has left monetary and fiscal policies vulnerable to the demands of special interest groups. The representatives of state industry and agriculture, in particular, have lobbied successfully for large fiscal transfers and subsidized credits from the central bank to cover financial losses, tax payments, and accumulated inter-enterprise arrears.

The staff report correctly asks whether the necessary consensus can be mobilized to translate policy intentions into actions that hold. Alas, continuing political chaos and fighting between the President, the Prime Minister and Government, and the Parliament, is very distressing. It is difficult to imagine ambitious economic policy actions being contemplated--never mind their being implemented--until the political situation is resolved.

I would like to thank the staff for dealing in such a comprehensive and yet succinct manner with what is obviously a very troubling situation, both economically and politically, and for setting out both the problems and the solutions in a very readable and clear fashion. We agree with the thrust of these recommended solutions.

The staff reports that the Ukrainian authorities expect a sustained deterioration in the country's balance of payments associated with the movement to world prices, in particular for the country's energy imports from the Russian Federation. This argument underlies Ukraine's demand for large-scale external financing. However, to attribute a chronic balance of payments deficit to higher prices for energy imports is misleading. Although the movement to world prices for Ukraine's energy imports will lead to a sharp decline in the country's terms of trade, and will temporarily exacerbate the payments deficit, chronic payments deficits reflect an excess of aggregate demand over current income. This reflects, in turn, lax macroeconomic policies.

So, the Ukraine wants to borrow money from abroad so that it can stretch out the adjustment and therefore try to make it more politically and socially palatable. Of course, the new debt must be serviced and ultimately paid back; thus, the total adjustment costs are actually higher, with more being pushed onto future generations.

We could ask oil-importing less developed countries how well that particular blueprint worked in the 1970s, and the effects of this on their economic fortunes in the 1980s. Another possibility is to let the exchange rate depreciate, but this involves a further terms of trade loss, and it redistributes income within the country by changing Ukrainian domestic prices relative to international prices, instead of allowing one price--energy--in Ukraine to rise relative to all others in Ukraine.

There is also the "bite the bullet" option, which is to pass on price increases fully to consumers and business and not to allow the price level change that this causes to become inflationary. Real incomes decline substantially, but then the adjustment is over, and the country can get on with life in the real world. Did not the 1970s teach us, if nothing else, that this is really the only way to go?

The staff report notes on page 9 that a recurrent theme of Ukraine's Plan of Action is the need to re-exert state control over the economy and stabilize production before proceeding much further with liberalization. I believe that this is totally wrong. It is like moving two steps backward to move one step forward; that is not progress.

No amount of new taxes, regulations, controls, quotas or subsidies can replace appropriate macroeconomic stabilization and thorough-going structural reform, or reduce the costs of adjustment. All they do is delay adjustment, and ultimately increase its costs.

This takes me back to the question of whether of not Ukraine is ready to reform. That is the same as asking whether or not Ukraine wants to lift its standard of living in the long term, or does it want to condemn itself to stagnation as it continues its fruitless search for gain with no pain? This reminds me of the popular aphorism, "no pain, no gain." We should keep that in mind; that is, in fact, the only way to go.

Mr. Mwananshiku made the following statement:

Let me thank the staff for presenting a lucid report on the economic situation in Ukraine, including suggestions of the measures that need to be taken urgently to put the economy on the road to macroeconomic stability and sustainable growth.

It was expected that the breakup of the Soviet Union, including the ending of the existing trading and payments system, would impose some costs on the individual republics. In the case of Ukraine, these costs have been increased by the fact that the previous system of managing the economy has not yet changed to accord with the current momentum toward market-based economies. As a result, responsibility for the management of the economy remains fragmented, with the Ministry of Finance not playing a central role, and the National Bank continuing to be legally responsible to Parliament.

As we have seen elsewhere, these arrangements are not conducive to the implementation of strong macroeconomic policies. On the contrary, they tend to lead to expansionary fiscal and monetary policies, as is now evident in Ukraine. Thus, some of the current economic problems facing the country have their roots in this rather tentative manner of managing the economy.

I am referring to what the staff calls a dramatic weakening of the budget and a massive expansion in credit. In the case of the budget, total expenditure, including the credit mandated by Parliament and the extrabudgetary pension, social assistance, and labor funds, reached the unprecedented level of 75 percent of GDP, resulting in a general government budget deficit of 28 percent of GDP, all of which was financed by the banking system.

At the same time, credit to enterprises also surged. The reasons for the rapid growth in credit have been fully explained by the staff, and basically originate from the pressures implicit in the present system of managing the economy.

With expansionary fiscal and monetary policies, it was no surprise that inflation emerged as one of the most serious problems facing the country, leading to a decline in GDP and forcing the authorities to both leave the ruble area in mid-November 1992, and subsequently to replace the ruble with a local currency.

These domestic imbalances were accompanied by equally severe balance of payments difficulties. These arose partly from the expansionary domestic policies, but also from the contraction of external trade, including a deterioration in the terms of trade. Particularly important in this regard is the fall in the volume of oil imports, and a subsequent increase in prices that has affected production in many of the state enterprises.

Only modest progress was made in the area of structural reform, although the authorities were able to enact a number of key pieces of legislation and free some of the prices. Since then, the Government's efforts, including the Plan of Action launched by the authorities, have had only modest results.

The somewhat contradictory nature of some of the objectives and the limited progress made in implementing key measures, such as those relating to the budget, credit, prices, and the trade and payments system, highlighted some of the difficulties facing the authorities.

Against this background, and taking into account the fact that the efforts currently under way are unlikely to stabilize the economy, we agree with the staff that the authorities should now commit themselves to combating inflation not only by adopting the policies recommended by the staff, including targeted safety nets, but also by creating the political and administrative mechanisms to ensure that these policies are actually carried out. In this regard, the position and responsibilities of the Ministry of Finance and the National Bank in the management of the economy should be clarified.

At the same time, measures should be taken to address the balance of payments crisis. In particular, efforts should be made to limit energy consumption and expand exports.

Ultimately, what is required is a comprehensive adjustment program that can be supported by the resources of the Fund and those of the international community, including technical assistance. I hope that rapid progress can be made in this direction.

Mr. Dorrington stated that he agreed with the broad thrust of the staff appraisal and with other Directors' endorsement of it. He recalled that Mr. Zhang had said that the deficit currently had to be financed in full by the banking system. He wondered whether there was any prospect of that changing, perhaps by starting to finance the deficit with treasury bills, and then moving on to other instruments. He also wondered whether the staff could provide any additional information about the status of the negotiations about the division of the assets and liabilities of the former Soviet Union.

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

Our views on developments in the Ukrainian economy are similar to those of previous speakers, and we are in broad agreement with the staff appraisal.

We note that, like the other countries of the former Soviet Union, Ukraine is facing enormous challenges not only in restructuring its economy, but also in building the institutions needed for the proper functioning of a market economy. Mr. Havrylyshyn's statement shows the extent of these difficulties, especially when the achievements of the authorities are compared with the economic program presented last year. We sympathize with the authorities in their arduous tasks. It is obvious that the transition from central planning to a market-based economic system is proving to be much more difficult than anticipated. However, it is reassuring to read from Mr. Havrylyshyn's statement that the Ukrainian authorities remain committed to the reform process.

The staff report enumerates the major issues facing the authorities. We are in general agreement with the staff's analysis, and we share its policy recommendations. In particular, we agree that the Ukrainian authorities must resolutely implement sound macroeconomic policies. The domestic and external financial positions are deteriorating at a rate that should be of major concern to the authorities. Therefore, there is an urgent need to restore financial policy discipline and create the appropriate mechanisms that will allow for the effective implementation of these policies. In this context, we note the extensive technical assistance programs provided to Ukraine. Given the institutional problems and those of governance referred to by Mr. Havrylyshyn, we wonder how well the recommendations are being implemented. In any event, we urge the authorities to take the steps necessary to allow for an effective implementation of those recommendations, which can only help to smooth the transition to a market economy.

We join previous speakers in encouraging the Ukrainian authorities to put in place a coherent program of economic reforms that addresses urgently the problems of inflation and fiscal imbalances. Without such a program, Ukraine's economic and financial situation can only worsen and increase the future cost of adjustment. Moreover, clear indications of progress in the implementation of macroeconomic and structural measures along the lines suggested by the staff will certainly help Ukraine to qualify for Fund assistance under the systemic transformation facility and attract additional external resources.

We support the proposed decision.

Mr. Solheim made the following statement:

Like previous speakers, I found the staff report on Ukraine very unsettling. Indeed, time may be running out to prevent a looming economic crisis from developing. Previous speakers have thoroughly covered Ukraine's grave economic situation, and I agree with most of what has been said. I shall therefore limit my remarks to a few areas, even though the good and broad analysis presented by the staff could have nourished a much wider range of thoughts and comments.

If 1992 was by and large a year of lost opportunities and painful lessons, these trends seem to be continuing into 1993 as well. A political deadlock remains to be broken before fundamental issues of economic policy can be resolved. I note Mr. Havrylyshyn's sobering remarks on the problems the authorities are facing with solving constitutional and governance issues. While I appreciate the difficulties of developing a conducive political and administrative framework for the implementation of appropriate economic policies, the progress in this area appears to have been disturbingly slow.

This is so much more unfortunate because Ukraine still holds a wealth of economic promise. The country used to be the "bread basket" of the former Soviet Union, and has the potential to join the group of the world's rich societies. Its labor force is well educated, agricultural land remains fertile, and there are significant mineral deposits to explore.

The establishment of an efficient decision-making structure remains essential to promoting a stable monetary policy and budgetary discipline. The staff ably describes the required policy steps, and I fully agree with the staff appraisal and with its focus on the necessity for the authorities to take decisive action to restore financial policy discipline, to develop an effective strategy to deal with the imminent deterioration in the terms of trade, and to accelerate structural reforms. The staff's advice for the Government to work intensively with the World Bank and the European Bank for Reconstruction and Development (EBRD) in moving forward is well placed. The Fund itself must continue to extend technical assistance, as the need for training and guidance appears substantial.

The last time the Board discussed Ukraine, we stressed the particular responsibility of a large country within the group of the former Soviet Union for maintaining open trade relations, and the benefits that would derive from open trade relations to Ukraine itself. While we welcome the recent measures to liberalize the export regime, very much remains to be done.

An acceleration of the dialogue between the authorities and the Fund is highly desirable, so that measures can be put in place quickly to enable Ukraine to qualify for assistance under the systemic transformation facility. It is to be hoped that the required discussions will not be obscured by further political instability. Without coherent and comprehensive policy actions in accordance with the advice of the Fund, Ukraine's economic performance will continue to deteriorate.

Mr. Mancebo made the following statement:

Ukraine has been one of the countries most affected by the dissolution of the former Soviet Union. As a result of political and institutional paralysis, the introduction of fundamental reforms needed for a market-based economy has been made more difficult.

I share the thrust of the staff appraisal. Reducing inflation is a prerequisite for a successful market transition, and requires a radical tightening of budget and credit policies. Equally important will be the strengthening of related mechanisms for policy implementation. It is crucial that the new Government give impetus to structural reforms. Acceleration of the privatization program, not only in the housing area, but also, and more fundamentally, in the agricultural sector and large enterprises as specifically promoted in a 1992 Government decree, will constitute an important signal of the authorities' commitment to reform.

Restricting the involvement of the National Bank in the allocation of subsidized directed credits will be paramount in the new Government's aim of strengthening its emergency powers.

Financial discipline is not feasible without price liberalization. Progress in this regard will be even more painful to the extent that key prices fail to reflect the relative scarcity of goods and services, and to the extent that competition and the profit motive are absent from prevailing management practices. The elimination of subsidies, profit ceilings, and sales regulations through official channels need to be complemented by appropriate bankruptcy legislation. In the same vein, state orders are incompatible with an efficient allocation of resources based on needs and preferences. While the adjustment of relative prices to market and world conditions can have an adverse short-term impact on the lower income segments of the population, social safety nets will also need to be both streamlined and targeted more selectively.

Considering the deep-rooted difficulties in the transformation process, it is also crucial that the Fund be prepared to continue its assistance in program design. Resident experts in key areas might also be considered useful to coordinate policy advice and bolster policy implementation capabilities.

Given the fact that Ukraine is a large net importer of oil and natural gas, there is considerable uncertainty and concern about the vulnerability of Ukraine's balance of payments to a further increase toward world market levels of the price of energy supplies from the former Soviet Union. However, Ukraine's rich endowment of natural resources--in particular, agricultural land--also affords it a unique opportunity to contribute to regional growth prospects. Progress on domestic stabilization, including the elimination of the antiexport bias of the trade regime, could nevertheless be enhanced substantially by a successful conclusion of the Uruguay Round, predicated upon the liberalization and reduction of agricultural export and production subsidies by industrial countries. Trade is seen as the most efficient mechanism for helping to contain the sizable financing gaps and sustain Ukraine's growth prospects in the medium term.

Strong cooperation between Ukraine, the Fund, and the international community will be called for if the long and difficult process of economic and political transformation that the country has initiated is to succeed.

Mr. Link made the following statement:

We are pleased to have the first Article IV consultation with Ukraine before the Board today. Ukraine is the largest country of the former Soviet Union--after the Russian Federation--with the potential to be a country with a strong economy in the future. As presented in the staff report, at present Ukraine faces many problems typical of the initial stage of the transition process, such as the overly centralized direction of production and distribution, very high inflation, a traditional, passive role of monetary policy, a dramatic weakening of the budget, and a massive expansion in credit to enterprises. In the absence of a hard budget constraint, enterprises tend to focus on short-term objectives, especially on maintaining employment and increasing wages.

I generally share the staff's view that, in order to accelerate the transition to a market economy, it is necessary to pursue a policy aimed at both financial stabilization and economic liberalization. In this regard, I would like to stress the following points.

While a large part of the legal framework for the implementation of the reforms has been created, there is still a clear need for an institutional setup allowing for the conduct of a priority-oriented macroeconomic policy. This is also true for the privatization scheme. Small-scale privatization that goes beyond simple leasing might serve as a test case for the privatization of medium- and large-scale enterprises. We would expect that privatization in the agriculture sector could yield rapid results. The fact that the production of the former grain cooperatives declined again last year is an obvious matter of concern. A strong agriculture sector could serve as a supporting base for the economy as a whole.

The intention to substitute a new Ukrainian currency--the hrivnia--for the karbovanets in the wake of the stabilization of the economy is well understood. However, perhaps the staff could be more explicit about the issue, including about the possible timing of the introduction of the new national currency.

As in the case of other Eastern European economies, Ukraine's economy is highly energy intensive. A price system that would progressively bring prices closer to the world market level could have a significant effect on energy consumption.

Foreign direct investments could play an important role in assisting the transformation process, through the transfer of skills and technology, the provision of capital, and the development of export opportunities. In spite of the work done on the legal framework, important impediments to foreign direct investment remain. We consider that Ukraine is potentially attractive to foreign investors.

A further decline in the economic situation of Ukraine is liable to aggravate the country's regional disparities, and could thus lead to internal tensions. A more decentralized and regionalized decision-making process could be helpful in this context.

There is a need to protect vulnerable social groups during the transition, as well as over the longer term. However, affordability and simplicity should be the guiding principles when designing a social safety net.

I share Mr. Havrylyshyn's opinion that the year 1992 was for Ukraine a year of lost opportunity for economic reform. As

Mr. Havrylyshyn expressed further that there are no differences between the Ukrainian authorities and the Fund concerning program orientation, the only problem is effective implementation. This chair would like to encourage the Ukrainian authorities to quickly put in place measures that would enable Ukraine to qualify for financial assistance. In this respect, I would like to ask the staff what prior action it envisages for Ukraine in order to allow it to benefit from the systemic transformation facility.

I support the proposed decision.

Mr. Hammoudi stated that he had some concerns about the confusion of responsibilities for economic and monetary policy in Ukraine. In particular, the treasury and the central bank should be kept free from political influence if economic reforms were to succeed. If the authorities showed a greater commitment to market instruments and structural reforms, financial support might be forthcoming more quickly. He hoped that the systemic transformation facility would be available to Ukraine to allow it to overcome its financial and economic difficulties. He could go along with the proposed decision.

The staff representative from the European II Department stated that, regarding the question that had been raised about measures to contain interenterprise arrears, it was at present common practice--although by no means uniformly observed--for exports to other states of the former Soviet Union to require prepayment; this had alleviated the inter-state element of the problem as far as Ukrainian enterprises were concerned. One factor that had fed interenterprise arrears in early 1992 had been the making of shipments to other republics regardless of the ability of the purchaser to pay.

The critical matter with respect to payments within Ukraine remained changing the rules of the game in a credible fashion, so that enterprises understood that it was not business as usual, the staff representative commented. To that end, the authorities had declared publicly that the most recent operation to settle interenterprise arrears would be the last one. The increase in interest rates might have an even more important influence on enterprise behavior, to the extent that the rate of return might cause enterprises to see a profitable alternative use for their resources, other than blindly to extend credit to their customers, as had been the case in the past.

The authorities hoped to begin nonbank financing of the budget deficit, starting with treasury bills, in 1993, the staff representative noted. Work on that was at an initial stage, with technical assistance from the Fund.

There had been no further developments with respect to the negotiations on the disposition of the assets and liabilities of the former Soviet Union, the staff representative remarked.

With regard to the introduction of a new currency, it was well understood by the staff's principal interlocutors in Ukraine that an absolute prerequisite for the new currency was financial stability, the staff representative concluded. The authorities did not wish the new currency to experience the same fate as the karbovanets.

Mr. Havrylyshyn stated that he understood that Parliament had approved the monetary program presented to it by the National Bank of Ukraine. The concern was that the Parliament might not be able to keep to it very well. However, it needed to be emphasized that, in the same way that, since November 1992, Ukraine had had its own currency--of which the authorities saw themselves as responsible for defending the value on international markets--the Parliament now had a program for which it would be held responsible before the people. The people would hold Parliament responsible for keeping to that program or overrunning it, and for the consequences of overrunning it.

A program under the systemic transformation facility should have as its focus not only financial stabilization per se, but also monetary control mechanisms, including credit ceilings and appropriate refinance rates, Mr. Havrylyshyn commented. The actions that had already been taken by the authorities would seem to go a long way in the spirit--if not the letter--of such a focus. A refinance rate of 20 percent a month, and the start-up of the credit auctions, were steps forward. More important would be the ability of the Government to push through a decree specifying not only a refinance rate and periodic credit auctions, but also that that refinance rate would apply uniformly to all borrowers; allowing a significant proportion of economic agents to benefit from a preferential refinance rate would not be very meaningful. The Government appreciated the need not only to raise the refinance rates, but also to apply them effectively.

Regarding the trade and payments arrangements between the countries of the former Soviet Union, he had appreciated Mr. Kagalovsky's candor in being explicit about the Russian authorities' lack of support for a payments union approach, Mr. Havrylyshyn remarked. While he agreed that the issue need not be explored in depth at the present juncture, the Ukrainian authorities nevertheless favored a payments union-type mechanism as a second-best solution in the period before the firm establishment of current account convertibility and stability. It might be borne in mind in that connection that the European Payments Union was established only four to five years after the first discussions about it had taken place, so he would not necessarily abandon completely the idea of a payments union among the states of the former Soviet Union. In that sense, he was perhaps more optimistic than Mr. Schoenberg about it. That notwithstanding, there could be no argument that the first-best solution was current account convertibility and stability.

It was perhaps unfortunate that the Article IV consultation cycle covered a period of one calendar year rather than an economic policy phase, Mr. Havrylyshyn observed. There had been a clear break in policy orientation from October 1992. He had appreciated in particular in that regard the comments of Messrs. Kagalovsky and Lanciotti, who had recognized the substantial difference between the new policy orientation and the previous one. While the end result might indeed be the same, there was a difference between a government that was not pursuing reforms because of a lack of commitment, and one that was not pursuing reforms because of hindrances in its powers of implementation in spite of its firm commitment to reform. The case of Ukraine was clearly the latter at present, and, as Mr. Lanciotti had stated, Ukraine deserved the strong encouragement of the international community.

The authorities had been candid about their lack of achievements, Mr. Havrylyshyn stressed, and also had not overdramatized their real success in some areas. For example, in assessing the progress made in privatization, the authorities could have included so-called "spontaneous privatizations" in the statistics on privatization, but had chosen not to do so. The Government had recognized that spontaneous privatization was not the optimal privatization solution, and therefore they were not included in the privatization numbers. Also, the Government had not emphasized the fact that about 50,000 new enterprises had been created in Ukraine, of which not all were either simply spin-offs from existing state enterprises or in the commercial sector. In the same vein, the Government had not stressed the fact that between 10,000 and 20,000 new private farmers had been established, with plots of more than 10 hectares, on average. Rather than flaunt their successes, the authorities had decided to admit their disappointment that more could not have been accomplished.

The Prime Minister had spoken candidly about the fact that 1992 had been a year of lost opportunities for Ukraine, Mr. Havrylyshyn went on. The candor of which that comment was evidence had grown. Despite the fact that the Prime Minister and his cabinet had attempted to implement several harsh measures that individuals might not have been particularly happy about, the popularity of the Prime Minister had been rising steadily. In that respect, he agreed with Mr. Smee's comment that in the case of Ukraine, there would be no gain without pain.

In assessing the degree of success in introducing a national currency in November 1992, it needed to be borne in mind that an exchange market had not existed in the country 18 months previously, and that valid judgments about the decline in value of the currency could not be made on the basis of such an inefficient and slim market, Mr. Havrylyshyn pointed out. Following its introduction the currency had fallen immediately, reflecting the Government's policy of allowing it to feel the shock of built-up depreciation. The extent of the decline was worst vis-à-vis the Russian ruble, against which the balance of payments situation was the least favorable. The decline might not have been seen as so great were other currencies to have been used as the metric. Indeed, since the achievement of some degree of stability in the markets in late January-early February 1993, along with a modestly functioning exchange market, the depreciation of the Ukrainian karbovanets had tended to follow the depreciation of the Russian ruble. The markets were becoming more efficient. One good indication of that was the fact that the cross rates currently made some sense. Indeed, the fact that the cross rates had not make sense three to four months previously should be an indication that any analysis should not pay too much attention to what was happening in that period.

With respect to Mr. Schoenberg's comment on Gresham's Law--that bad money drove out good--it needed to be borne in mind that, after the dissolution of the Soviet Union, there was a period in which there was no real money anywhere, Mr. Havrylyshyn commented. At present, it was well understood by the policymakers that the value of the karbovanets in foreign exchange markets was attributable to what was happening in Ukrainian economic policy, which he believed was in itself an important achievement.

A number of speakers had called attention to the fact that if the economic deterioration continued, there would be a real danger of social unrest, Mr. Havrylyshyn recalled. While that concern needed to be borne in mind, it was important that it not become a fixation. Concerns about social unrest had often been a reason--or an excuse--for not moving ahead with reform in many countries, including in Ukraine in the past. An important change in the attitude of the current Government was its realization that there would be some social unrest that would have to be dealt with, but that the only solution was to go ahead with the reforms. The authorities might take heart from the fact that social unrest might take on substantial dimensions in the quantitative sense, but not in the qualitative sense. For example, it had been reported that miners on strike in eastern Ukraine had sat on the grass in a municipal park and eaten sandwiches thoughtfully provided by the local government. Thus, social unrest might not lead to the tremendous violence that was sometimes feared.

He appreciated the many remarks of Directors who had emphasized that a consensus on economic reforms needed to be achieved, Mr. Havrylyshyn concluded. The upcoming referendum would have important implications in that regard. However, the question could be raised as to how much consensus and clarity was needed before substantial economic reforms could be embarked upon. It would surely be inappropriate to wait until there was a unanimous consensus among all parties before going ahead. He also appreciated the remarks of several Directors about the need to continue the dialogue on preparing a program under the systemic transformation facility, with the intention of transforming that program quickly into a stand-by arrangement.

The Acting Chairman made the following summing up:

Executive Directors endorsed the basic recommendations found in the staff appraisal. Directors emphasized in particular three critical and related tasks now facing the Ukrainian authorities: the establishment of financial stabilization, the restoration of a sustainable balance of payments position, and the adoption of a broad and consistent approach to market reform. Directors stressed that a more coherent and forceful policy response would be essential if increasing economic disruption and instability were to be averted. A prerequisite was the quick resolution of current uncertainties regarding the responsibility and authority for economic policy, which should be followed by the establishment of clear policy priorities and objectives endorsed by the Government at large.

Directors were agreed that a decisive reduction in inflation was essential, and that that required a substantial tightening of budget and credit policies. Following recent upward adjustments in prices and wages, the need for strong measures was more urgent than ever if a price-wage spiral was to be avoided. Directors were encouraged to learn that Parliament had recently approved a quantified monetary program for the remainder of 1993 aimed at reducing monthly inflation to a single-digit rate by the end of the year. They also welcomed recent moves by the National Bank of Ukraine to raise interest rates substantially and to begin auctioning central bank credit to the banking system. Speakers wondered, however, whether the monetary program would be fully respected, and in that regard, concern was voiced about reports that Parliament continued to issue ad hoc instructions for credit to be extended to specified sectors. Such directed credits would work to undermine any attempt to control total credit and, hence, to bring down inflation. The central bank would remain vulnerable to the demands of special interests as long as it retained a role in allocating directed credits to the economy. The authorities were therefore urged to limit strictly the volume of such credits within the program, and to end the participation of the central bank in their allocation.

Directors commended the authorities' ambition to contain the budget deficit in 1993 to about 6 percent of GDP. However, they considered that that would require considerably stronger measures than those envisaged in the current budget, all the more so given the recent increases in wages, pensions, and subsidies. While some contribution to deficit containment should be sought from a reduction in tax exemptions, most of the adjustment would need to come from deeper cuts in government expenditure, the projected level of which was incompatible with the development of a market economy. In the prevailing circumstances, rigorous cash management of the budget, limiting outlays in relation to revenue receipts, was also likely to be essential to realize the budget objective.

Progress in the area of price liberalization had been uneven, and the remaining price controls had generated rising subsidy costs for the budget and additional demands for credit from affected enterprises. Directors stressed the importance of free prices in promoting market development. Where controls and subsidies could not be eliminated, they should be tailored to what the budget could afford and be reduced progressively.

Progress thus far in the area of systemic reform was viewed as disappointing. Directors emphasized that accelerated structural change was needed both to mitigate the costs of financial stabilization and to hasten the subsequent recovery in output, employment, and living standards. They urged the authorities to strengthen in particular the governance of state-owned enterprises and to accelerate enterprise privatization, proceeding immediately with comprehensive small-scale privatization. Speakers also underscored the need to remove administrative obstacles to the formation of new businesses, to move forward rapidly on land reform, and to dismantle the system of state orders.

Directors noted that, with macroeconomic and structural adjustment, open unemployment was likely to increase significantly. They saw that as giving added urgency to a radical streamlining of the social safety net aimed at trimming generalized handouts and enhancing support for the most vulnerable groups.

Directors underscored the seriousness of the balance of payments situation now facing Ukraine. The prospective external financing gap for 1993 was large, and its financing far from secured. While prudent financial policies would help to narrow trade imbalances and encourage repatriation of export earnings, more direct measures were needed in addition. Above all, with a view to stimulating exports, the authorities were urged to build on recent measures to remove export quotas and cut export tariffs. Directors welcomed other recent steps taken to liberalize the exchange and trade system, notably the introduction of a high degree of current account convertibility, the abolition of foreign exchange taxes, and the establishment of a liberal import regime with regular auctions for foreign exchange. At the same time, Directors expressed concern regarding the prospective deterioration in Ukraine's terms of trade, particularly in the energy field. They welcomed the recent debt agreement between Ukraine and Russia, but cautioned against a rapid buildup of foreign currency debt. Directors emphasized the importance of Ukraine's cooperating closely with its traditional trading partners to promote trade, improve the efficiency of the cross-border payments system, and strengthen financial and credit relations.

With successful policy implementation, Ukraine would require substantial external financing in the period ahead. Under those circumstances, Directors regretted that political events and the absence of a consensus on a coherent economic strategy had held up negotiations toward assistance under the systemic transformation facility. They hoped that the outlook for policies would be clarified quickly, permitting discussions to resume in the near future. Given the scale of Ukraine's external financing needs, Directors encouraged the authorities not only to adopt policies that the Fund could support under the systemic transformation facility, but to build quickly thereafter on those policies, elaborating a comprehensive program that would warrant a stand-by arrangement in the upper credit tranches, and hence catalyze the widest possible financial support from the international community.

Directors encouraged the authorities to make more effective use of the Fund's technical assistance facilities. Hands-on advice provided by resident advisors could yield major benefits.

It was expected that the next Article IV consultation with Ukraine would be held on the standard 12-month cycle.

The Executive Directors adopted the following decision:

1. The Fund takes this decision relating to Ukraine's exchange measures subject to Article VIII, and in concluding the 1993 Article XIV consultation with Ukraine, in the light of the 1993 Article IV consultation with Ukraine conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Ukraine maintains multiple currency practices and restrictions on payments and transfers for current international transactions, described in SM/93/115 (5/26/93), in accordance with Article XIV, Section 2, except for the multiple currency practice arising from the National Bank of Ukraine's practice of engaging in spot exchange transactions at buying and selling rates whose spread exceeds 2 percent, which is subject to approval under Article VIII. The Fund encourages Ukraine to eliminate the measures maintained under Article XIV, Section 2 as soon as its balance of payments position permits, and urges Ukraine to eliminate the multiple currency practice that is subject to approval under Article VIII.

Decision No. 10395-(93/87), adopted
June 23, 1993

2. ST. KITTS AND NEVIS - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with St. Kitts and Nevis (SM/93/110, 5/19/93). They also had before them a background paper on recent economic developments in St. Kitts and Nevis (SM/93/119, 6/4/93).

Mr. Murphy made the following statement:

The authorities wish to thank the staff for its analysis of the economic situation of St. Kitts and Nevis; the outcome of the mission that formed part of this Article IV consultation was especially welcomed. They are in general agreement with the analysis in the report, and share broadly the recommendations set out therein.

In 1991-92, real output grew strongly, averaging close to 6 percent over the period, following the sudden slowdown in economic activity in the aftermath of hurricane Hugo in 1989. Inflation is estimated to have declined to 2.9 percent in 1992 from 4.2 percent the previous year, reflecting chiefly the stabilization of import prices. An improvement of public sector finances was sustained in 1992, with public sector savings recovering to about 8 percent of GDP, compared with 5 percent in 1991.

The continued strong growth in economic activity was led by tourism following the completion of a major resort hotel in Nevis in 1991. The expansion in tourism activity also brought about spin-offs in other service-related sectors and, along with favorable weather conditions, both sugar and nonsugar agriculture improved also--with the latter at the forefront.

The authorities are mindful that a large part of the improvement in the balance of the public sector was attributable to a substantial drop in investment spending. In order to provide for essential investment in infrastructure, a necessary condition for maintaining strong growth, they intend to strengthen savings considerably over the medium term, and they recognize that this will require a special effort. To this end, they are continuing to pursue measures aimed at improving tax administration; increasing the collection of arrears, and streamlining the system of customs duty exemptions and other fiscal incentives. To complement this fiscal effort they have begun to streamline the public sector and intend to contain expenditures on current transfers. The authorities have already embarked upon a program to strengthen the financial operations of certain public enterprises and adopt changes in other commercial activities in which the Government is presently engaged.

The provision of adequate infrastructure and incentives, the authorities believe, will be essential for further broadening of the economic base. They intend to continue with their efforts at encouraging agricultural diversification, as they can see that there is considerable scope for greater linkages between nonsugar agriculture and the tourism sector, and also to increase exports within the region. As regards manufacturing, the authorities intend to continue with the provision of selected fiscal incentives to attract new investment in the sector; they note the staff concerns about system transparency, and they are willing to deal with this. In addition, they have already begun to develop a third industrial estate in anticipation of increased demand for factory space.

The authorities are aware that, in order to carry out their development program, there is a further need to strengthen the capacity of the public sector. In this regard, they intend to continue with efforts aimed at strengthening project identification and preparation. They believe that this task could be greatly assisted by early identification of projects for financing by the donor community, as well as timely disbursement of resources.

On a related point, while the authorities intend to conduct a policy of wage restraint supported by a flexible immigration policy in those sectors facing labor shortages, they are also aware that the wide gap that exists between public and private sector pay hampers their ability to recruit and retain qualified staff within the public sector. They will have to work to reduce the gap, for which they have recently used bonus payments, while keeping the overall wage bill under control.

Mr. Bindley-Taylor made the following statement:

The staff report on St. Kitts and Nevis presents a picture of a well-managed and thriving economy. Real GDP is growing in excess of 6 percent a year, domestic saving is increasing, inflation is low, the external current account deficit is progressively narrowing, and private capital inflows continue to be in excess of the external current account deficit. We are in broad agreement with the assessment in the staff report.

Notwithstanding the good overall performance of the economy, we note a certain weakening of the fiscal position of the Central Government. Although the central government deficit declined from 2.1 percent of GDP in 1990 to an estimated 1.7 percent in 1992, the fall in the ratio of revenues to GDP--from 25 percent in 1990 to an estimated 22 percent in 1992--is cause for concern. This appears to have occurred despite a substantial increase in collection of taxes on domestic production, and seems to reflect stagnation in collection of income taxes, international trade taxes, as well as declines in nontax and capital revenues. The staff indicates that difficulties in tax administration were responsible for this fall in the ratio of revenues to GDP. Hence, we would strongly endorse the staff's recommendations with respect to strengthening tax administration, and we are pleased to note in Mr. Murphy's statement that the authorities intend to act decisively in this direction. In addition, we would urge the completion of the exercise on the revaluation of real estate and the imposition of more realistic property tax rates. There also seems to be scope for increasing revenue in certain nontax areas, such as fees and licenses. For example, we note that the fees on the gross takings from professional services and on certain categories of traders seem quite low. We would also like to suggest that, in light of the need to enhance revenue, continuation of the liberal use of tax incentives to promote investment should be reconsidered.

We note that while total expenditure as a proportion of GDP declined by 3 percentage points between 1990 and 1992, the composition of expenditure has changed significantly in the last two years. Wages and salaries now represent 45 percent of total expenditures compared with 41 percent in 1990, and the proportion of transfers and interest payments in total expenditure has also grown over this period. In contrast, capital expenditure as a proportion of total expenditure has remained fairly constant.

With respect to the growth in current expenditure, the staff indicates that the increase in the total wage bill in 1991 was due to an additional number of casual workers on the Government payroll. In 1992, the total wage bill increased by 10.7 percent, of which 8.3 percent represented an end-of-year bonus for all employees. Perhaps the staff could indicate what is the status of the casual workers originally hired in 1991. More specifically, although we understand the award of bonus payments in lieu of salary increases, we do not understand how this generous bonus granted to all Government employees is expected to narrow the gap between public and private sector wages, which it is alleged hampers the recruitment of qualified persons to the public sector.

More important, are we to assume that the authorities intend to keep the same pay scale, but supplement it every year with bonus awards? If this is so, the announced policy of keeping the wage bill under control will progressively lose credibility. A *more appropriate way to narrow the public versus private sector* wage gap for qualified persons would be to increase the pay levels of qualified public sector employees, while rationalizing the numbers of staff in the rest of the public sector. Staff comments on this matter would be helpful.

The rest of the public sector has performed extremely well, and as a result, the deficit of the consolidated public enterprises, which stood at 1.7 percent of GDP in 1990, has been converted to an estimated surplus of 0.9 percent of GDP in 1992. This reflected mainly the improved performance of the Sugar Manufacturing Corporation and increases in the surplus of the social security scheme. With respect to the latter, we must commend the authorities for reversing the worrying trend of increasingly borrowing from the scheme, and for seeking budgetary financing through more appropriate instruments.

We are in agreement with the development strategy of the authorities laid out in the Public Sector Investment Program. However, we recall that, in the past, a shortage of technical personnel had affected both project preparation and implementation of the Program, leading to large under-execution of capital expenditure. We wonder whether the staff can tell us of any developments to strengthen the relevant areas of the public service with respect to project design and implementation. It is clear, however, that between falling external grants and the need to maintain external debt at prudent levels, increased levels of investment must be met by increased domestic savings over the medium term, and the management of public sector finances will be of critical importance.

The medium-term strategy of broadening the economic base and reducing dependence on protected sugar exports is commendable, and appears to have met with some success. There has been a broadening of the output and export mix in the agricultural sector, and growth now seems to have been led by strong performances in transport and communications, tourism, and manufacturing. This thrust at diversification is crucial, as the destruction wrought by Hurricane Hugo and the market uncertainties that affect neighboring banana producers indicate that good macroeconomic management can be easily undone by vulnerability to natural disasters--such as hurricanes--or man-made disasters, such as unsustainable preferential marketing arrangements.

We are therefore concerned about data deficiencies with respect to information on national income, inflation, and unemployment, as well as timely information on government operations and the balance of payments. We are uncertain whether this represents a weakness of inadequate staffing or inadequate training. Nevertheless, we urge the authorities to strengthen the system of statistical assessment and reporting, which will be critical to their ability to plan and promote their development strategy. To this end, Fund technical assistance could be helpful.

In the medium term, stable imports and rising exports are expected to result in a narrowing of the external current account deficit, while private capital inflows, although less than in the past, will prove adequate to finance the current account deficit and allow for a buildup of net international reserves. We are also pleased that the external debt, which had grown rapidly in the late 1980s, has more or less stabilized, that the proportion of short-term debt in total external debt has declined, and that the external public service debt ratio has fallen by almost 50 percent.

We commend the authorities on their prudent management of the economy.

Mr. Dorrington stated that he agreed with Mr. Bindley-Taylor's points about the statistical deficiencies in St. Kitts and Nevis.

He then made the following statement:

The economy of St. Kitts and Nevis continues to turn in a positive performance, having recovered well from the aftereffects of Hurricane Hugo, and it looks to continue healthy growth over the medium term. Due recognition must be given to the contribution that the authorities' efforts have made to this picture, most notably, their successful attempts to diversify the economy and to tap their country's undoubted potential for using tourism as the engine of growth. For the future, both the staff report and Mr. Murphy's statement provide assurances that the authorities clearly accept the areas in which further action will be needed: the public sector finances. Actions taken since the last Article IV consultation to improve significantly the position of the Sugar Manufacturing Company and strengthen tax administration bode well for the realization of commitments to action.

While I am assured that the will is there, I am less confident that the authorities are always clear on the details on how best to proceed. The proposed ambitious program of public investment--38 percent of GDP in the next four to five years--would demand a considerable effort to increase public savings. This chair expressed some concern at the last Article IV consultation about the heavy reliance on the surplus of the social security scheme to finance the development strategy. With the sharply diminished contribution to public savings from this source now in prospect, the success of the authorities' strategy will depend on a more fundamental approach to the public sector finances than in the past.

I acknowledge the magnitude of the task on the revenue side. Mr. Murphy's statement usefully enumerates several areas in which the authorities are acting along the lines of the staff's advice on tax administration, the collection of arrears, and the streamlining of fiscal incentives; all that is obviously welcome. To my mind, however, the authorities' decision to move in a new direction, or rather to enhance significantly their existing development strategy, provides an opportunity to review the overall coherence and transparency of both incentive and revenue-raising measures.

With respect to the former, I can see an argument in an economy of this size and openness about an appropriate role for fiscal incentives to bolster the diversification effort, but it is important that the argument is fully made in every case, and that such incentives are not regarded as the first option. In any event, they should not become so entrenched as to lead to long-term distortions, and recent growth in tourism suggests that some phasing out might be timely. I am happy with the idea of incentives that work more obviously with the market--through the leasing of public land to encourage high return agricultural products, for example--although I wonder whether this mechanism concealed an additional subsidy element, and whether there was any prospect of outright sales of land. I welcome what Mr. Murphy says about the acceptance of the need for improved transparency in the incentive system.

However, I also wondered what scope there was for a wide-ranging review of taxation, with a view to streamlining and improving the coherence of what looks from the background paper on recent economic developments to be a plethora of diverse instruments. The authorities' recourse last year to two very narrowly based new taxes as a means of bolstering central government finances certainly helped to do the trick, but it is another instance of the somewhat ad hoc approach that characterizes the fiscal system. One might think that singling out overseas telephone calls and restaurant meals for taxation would sit ill with a policy of encouraging tourism and private sector growth. I could also not help but notice that there appears to be a tax on what are called tax-exempt certificates.

I wondered whether the authorities could benefit from further technical assistance on these questions, either from the Fund or the Bank, although I am conscious that technical assistance must be a means, and not an end in itself. I welcome comments from the staff or Mr. Murphy on that.

With respect to the expenditure side, I agree that the size of the wage bill will be of key importance. I also had sympathy with the authorities' concerns that the effectiveness of their development strategy should not be jeopardized by a lack of institutional capacity and expertise in the light of continued problems with the evaluation and monitoring of projects. There may be a greater role for the World Bank here as well. I have in mind not only assisting with the design of a program consistent with and supported by an appropriate macroeconomic framework, but also in helping to coordinate the assistance of donors, or helping with development projects. Such assistance will need to be both financial and technical, and pay due regard to the training needs of those involved in project implementation. I quite agree, however, that the authorities would do well first to put in place the recommendations arising from the technical assistance they have already had from the Caribbean Development Bank and the UNDP.

Improvements in public sector expertise should not, however, put at risk a prudent wage policy. I can see the attractions of using bonus payments, provided that these are linked to performance and seen to be so, thereby contributing to productivity. The key will be to balance appropriate rewards with a streamlining of the public sector to create an effective but manageable work force. The heavy reliance at present in the private sector on overseas employees should provide the necessary room to prevent the streamlining process from posing a threat to St. Kitts and Nevis's currently comfortable employment situation.

I have one question on monetary policy. I note the staff's view that the 4 percent minimum interest rates on savings deposits may be contributing to the relatively high level of interest rates on lending, and I wonder what signs there are that other members of the currency union under the Eastern Caribbean Central Bank (ECCB) would be willing to go along with abolition of this.

Miss McDougall made the following statement:

Following the devastation caused by Hurricane Hugo, it is pleasing to witness the strong recovery under way in St. Kitts and Nevis. Mr Murphy's statement, and other speakers, have set out a range of positive indicators, with growth currently running at 6 percent and projected to remain strong, and inflation forecast to remain within a 2-3 percent range. Tourism is continuing to grow, in part because of the completion of major resort building projects, and this is providing both expanded job opportunities and a boost to foreign exchange earnings. Opportunities have also expanded for industries servicing the tourism industry, most notably the agricultural sector.

Perhaps because of the small size of the economy and its vulnerability to natural disasters, various indicators, in particular the fiscal position and the composition of revenue and expenditure, have been subject to significant fluctuations in recent times. The section in the background paper on recent economic developments relating to revenue shows the extent of these fluctuations, with revenue as a percentage of GDP declining by 4.6 percent from 26.3 percent over the period 1988-90, to 22.6 percent in 1991, owing primarily to a substantial drop in revenue because of difficulties in collection and an increased number of exemptions.

Although revenue as a proportion of GDP is estimated to have remained relatively constant over the last two years, the composition of revenue again changed significantly in 1992, with jumps in nontax revenue related to ECCB profits, departmental surpluses, and increases in numerous other taxes making up for a large fall in grants.

The development program envisaged by the authorities is based on high public savings, and to ensure that these savings are achieved, greater certainty about likely revenue flows is clearly desirable. Accordingly, I welcome the comments from the staff that measures continue to be implemented, based on the recommendations from the Commonwealth Fund for Technical Cooperation, to strengthen administration of revenue collection. Although continued effort will be required to further improve administration, some benefits are already emerging, such as a much better record of collection of arrears by the Government's electricity authority.

The Government's intention to continue to provide fiscal incentives to the tourism and manufacturing sectors through tax holidays raises some important issues. With tourism in particular playing such an important role in the economy, exempting this sector from tax and other duties severely restricts revenue-raising capabilities--even though part of this shortfall may be met by other taxes imposed on tourists. I would appreciate some comment from the staff as to whether these tax holidays could become infinite, through steps by owners to facilitate changes of ownership.

Expenditure in 1992 as a proportion of GDP also continued to fall, in part because of declines in capital expenditure. The authorities' development plan places priority on spending on infrastructure, in particular on energy, transport, water and sewerage in order to promote tourism, manufacturing, and the agricultural sector. With relatively few projects starting in 1992, expenditure by the Central Government on capital amounted to just 3 percent of GDP. Although capital expenditure is forecast to rise to around 6 percent of GDP in 1993, a sizable commitment is required to meet the target investment of 38 percent of current GDP over the next four to five years.

An important part of achieving the development goals will depend on strengthening the capabilities of the team managing and implementing the development program. Fund courses can provide some of the required training for public sector managers. In addition, seeking ways to attract technical assistance to aid implementation of the development plan would be a useful complement to possible financial assistance from donors mentioned by Mr. Murphy.

The authorities also intend to streamline the public service. Such a scaling back will not be an easy task, but it will be important if the funding is to be found to raise the salaries of remaining staff toward private sector levels so as to avoid loss of the most talented staff, especially in target areas such as security, tax administration, and infrastructure development.

The other dominant industry in St. Kitts and Nevis--sugar production--has shown significant increases in production since 1991, owing in large part to better weather and improvements in production and management methods. It would be interesting to know from the staff how the productivity of the sugar industry in St. Kitts and Nevis compares with other sugar producers. My question stems in part from the information that St. Kitts and Nevis would not be able to compete in international markets without current--but declining--price protection offered by the EC.

Further productivity gains should be possible, and perhaps the best way to achieve these is through privatization. The authorities' interest in further diversification of the agricultural sector is warranted, given the potential to gain higher yields from alternative crops that can be sold to tourist operators. Such a diversification could certainly prove a useful buffer to possible employment impacts stemming from sale of the Sugar Manufacturing Company, given the major role of this company as an employer of both citizens of St. Kitts and Nevis and of neighboring countries. While the Central Marketing Corporation has helped establish contacts between producers and buyers, I welcome efforts to develop private cooperatives and alternative marketing arrangements.

While the outlook for St. Kitts and Nevis remains favorable, continued application will be required by the authorities to further streamline the economy.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/86 (6/21/93) and EBM/93/87 (6/23/93).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 92/147, 92/148, and 92/150-92/152 are approved.

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAM/93/116 (6/18/93) is approved.

APPROVED: November 24, 1993

LEO VAN HOUTVEN
Secretary