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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/102

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

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
T. C. Dawson	
J. de Groote	J. Prader
	V. Kural, Temporary
I. Fridriksson	
H. Fukui	N. Tabata
	S. Ishida, Temporary
	T. Oya, Temporary
	A. Raza, Temporary
	K.-T. Hetrakul
D. Kaeser	
	J. C. Jaramillo
K. G. Kagalovsky	A. V. Mozhin
	E. Quattrociocche, Temporary
	D. Desruelle, Temporary
R. Marino	
A. Mirakhor	
L. J. Mwananshiku	
D. Peretz	J. Dorrington
G. A. Posthumus	
	Y.-M. T. Koissy
S. Schoenberg	B. Esdar
	G. M. Blome, Temporary
	W. Laux, Temporary
	Y. Y. Mohammed
	G. Lindsay-Nanton, Temporary
	Y.-H. Lee, Temporary
	Wei B.
	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
C. P. Clarke, Assistant

Also Present

IBRD: P. Adoteye and K. A. Lloyd, Europe and Central Asia Regional Office; B. Tuncer, Latin America and the Caribbean Regional Office. Administration Department: H. J. Struckmeyer, Deputy Director. European I Department: H. Vittas. European II Department: E. Brau, Deputy Director; E. Hernández-Catá, Deputy Director; F. Cartiglia, D. A. Citrin, G. Justice, I. Kapur, M. Shadman-Valavi, G. H. Spencer, C. R. Winkler, T. A. Wolf. External Relations Department: M. R. Kelly, Deputy Director. Fiscal Affairs Department: X. Maret. Legal Department: R. H. Munzberg, Deputy General Counsel; H. Cisse, R. B. Leckow. Monetary and Exchange Affairs Department: W. Coats. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; M. Allen, P. F. Allum, G. C. Anayiotos, S. B. Brown, D. Burton, H. M. Flickenschild, B. Horvath, A. K. McGuirk, J. G. Mikkelsen, J. P. Pujol. Research Department: M. Mussa, Economic Counsellor and Director. Secretary's Department: J. W. Lang, Deputy Secretary; B. R. Hughes. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; C. A. Hatch, D. P. Kelly. Western Hemisphere Department: S. T. Beza, Counsellor and Director; M. E. Bonangelino, L. A. Cardemil, L. E. Escobar, C. Gonzalez-Rodríguez, C. G. Muñiz. Personal Assistant to the Managing Director: G. R. Saunders. Advisors to Executive Directors: J. M. Abbott, A. Chang Fong, A. Cserés, S. K. Fayyad, G. Y. Glazkov, J. Jonas. Assistants to Executive Directors: S. Al-Huseini, D. A. Barr, M. Burdiel, M. Dzervite, N. P. Hahnemann, C. Imashev, A. M. Koulizade, T.-M. Kudiwu, K. J. Langdon, J. Mafararikwa, S. C. McDougall, F. Moss, S. del C. Olgiati, C. F. Pillath, R. K. W. Powell, N. Prasad, S. K. R. Regmi, P. L. Rubianes, F. A. Sorokos, Wang X., Wu H.

1. REPORT BY MANAGING DIRECTOR

The Managing Director said that he had recently traveled to Mexico, where he had attended a meeting for heads of international financial and development institutions. President Salinas described for the group the impressive progress made by Mexico in its efforts to achieve adjustment, growth, and social improvements. The presentation had convinced those present that strong adjustment designed to attain economic growth was the shortest path to social progress.

2. HONDURAS - 1993 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1993 Article IV consultation with Honduras and the midterm review under the first annual arrangement for Honduras under the ESAF (EBS/93/112, 7/12/93). They also had before them a statistical appendix (SM/93/156, 7/16/93).

The staff representative from the Western Hemisphere Department made the following statement:

> The Honduran authorities have informed the staff that on July 21 the Honduran Congress approved the asset revaluation tax and the reduction in the scope of the 10 percent import surcharge. On July 5, the authorities issued an executive decree eliminating subsidies on the use of fuel by cement companies, as of July 7, and on diesel and kerosene, as of January 1, 1994. A decree dated July 20 introduced toll charges on the use of the main roads, effective January 1, 1994. On July 15, the Board of Directors of the electricity company issued a resolution limiting investment to the amount incorporated in the revised fiscal program. In addition, on June 24 the Central Bank of Honduras adopted a resolution establishing an automatic monthly adjustment of the reference exchange rate used for customs valuation purposes to the level of the market exchange rate. With these measures, the authorities have introduced all the prior actions incorporated in the revised fiscal program.
>
> As discussed in the staff report, the lempira began to depreciate rapidly in May, and by early July the exchange rate had moved to L 7 per $1 in the interbank market and L 7.6 per $1 in the exchange house market from L 6 per $1 and L 6.2 per $1, respectively, at the end of April. Following the increase in reserve requirements on July 7, the lempira appreciated to about L 6.9 per $1 in both the interbank and the exchange house markets, and has recently stabilized around that level.

Mr. Marino made the following statement:

My Honduran authorities are in broad agreement with the staff report, which describes in great detail economic performance in Honduras under the ESAF arrangement. I would also like to convey their deep appreciation to the management and staff for their continued support and advice.

Since the introduction of a comprehensive stabilization and structural reform program in 1990, Honduras has continued in its efforts to restore confidence and promote sustained economic growth within a framework of financial stability. The program has aimed at consolidating the stabilization process and deepening the structural reforms, producing important results. Real GDP grew by 3 percent in 1991 and by almost 5 percent in 1992; the 12-month inflation rate declined more rapidly than envisaged in the program to 21 percent in 1991 and to 6.5 percent in 1992, from 36 percent in 1990; and net international reserves increased by $21 million in 1992, compared with a target, adjusted for shortfalls in program loan disbursements, of $15 million.

On the fiscal front, the overall deficit of the nonfinancial public sector declined to 4.8 percent of GDP in 1992 from 8.2 percent in 1990, while the current account surplus of the Central Government and the main public enterprises reached 3 percent of GDP, compared with 2.7 percent in 1991. Central government revenue remained at the same level as in 1991, namely, 16.7 percent of GDP. The full effect of the 1991 tax reform compensated for the decline in export taxes. Furthermore, the privatization of two cement plants contributed to the strengthening of revenues.

The current account balance of the main public enterprises improved in 1992 as current revenue increased as projected. This improvement in current revenue reflected the increase in tariffs of the electricity company. However, the larger than expected growth in current and capital expenditure led to an overall deficit of 0.4 percent of GDP.

On the external front, during 1992, despite the decline in the price of Honduras's main exports, the current account deficit remained at the same level as 1991. With the decline in inflation, real interest rates increased, attracting capital inflows. The flow of private capital contributed to the decline in the overall balance of payments deficit to $73 million, partially offsetting the shortfall in official capital inflows. It is important to point out that in order to fully re-establish its international financial creditworthiness, Honduras reduced external arrears by $152 million through arrangements that included rescheduling with the Paris Club and other bilateral creditors.

The structural reform effort in Honduras has advanced significantly. In September 1992, the Central Bank eliminated the interest rate subsidies on rediscounts for basic grains and advanced the implementation of an open market operations mechanism. The Government also removed the need for export permits for coffee, sugar, and edible oils and reduced the range of import duties from 4-35 percent to 5-20 percent. The complete elimination of the surcharge on imports is expected to take place by the end of 1993. Nevertheless, it is worth noting that only one third of the 650 customs tariff positions are still in place, partly because of the pending negotiations on tax harmonization with other Central American countries. Also, significant progress has already been made in completing the liberalization of the foreign exchange regime. In addition, a draft law on financial system reform has been sent to the Congress, and it is expected to be approved in the second half of the year. Except for the maintenance of the import surcharge, which is expected to be eliminated by the end of the year, all the structural reforms incorporated in the first annual arrangement have been introduced.

Even though economic performance in Honduras has improved significantly, my Honduran authorities recognize the weakened fiscal position in 1992 and in the first half of 1993. Public sector savings have not increased enough to finance increased public investment. Moreover, recent developments denote that during the first half of 1993 economic activity continued to expand but at a slower pace than in 1992, and inflation rose to 10.5 percent in the 12 months ending in June 1993. The resurgence of inflationary pressures and the weakened lempira have prompted further fiscal adjustments by the Honduran authorities.

Therefore, in order to restore confidence by bringing the fiscal deficit back to the path envisaged in the medium-term program and to accomplish the program targets, by end-May the Honduran authorities had introduced a fiscal plan aimed at sharply reducing the fiscal deficit. This reduction will arise from the strengthening of revenues--through new taxes and a faster adjustment of the reference exchange rate for customs purposes--and reductions in the public expenditures. It should be noted that the additional fiscal efforts are being undertaken during an election year.

To complement the fiscal plan, and in order to absorb excess liquidity and moderate inflationary expectations, the Central Bank decided on July 6 to increase reserve requirements by 7 percentage points, to reduce the rediscount operations by 20 percent of the outstanding stock, and to use more actively open market operations. The Central Bank has also prepared a monetary program aimed at lowering inflation to 6 percent during the remainder of the year and increasing net international reserves by

$110 million. All the fiscal and monetary measures discussed with the staff during the most recent mission have already been implemented.

In spite of all these efforts, the external sector remains fragile and vulnerable, as shown in the medium-term scenario. Nonetheless, my authorities are confident that the strengthening of the fiscal position and the support of the international community will contribute to the consolidation of the adjustment process.

The Government has continued its social safety net programs in order to provide short-term employment, reverse the nutritional deficiencies of poor mothers and young children, and improve the provision of water and basic sanitation.

My authorities are committed to continuing their efforts in 1994. The Government's objective is to reduce inflation to 5 percent and increase net international reserves by $50 million. The cornerstone of this program will be the further strengthening of the public finances through the elimination of the temporary subsidy for coffee producers, the introduction of toll charges, and the elimination of the remaining subsidies on oil derivatives. Furthermore, the Government intends to increase the scope of the sales tax in line with the harmonization of tax systems in the rest of Central America. The Government intends to recapitalize the Central Bank, lower reserve requirements, and increase open market operations. Approval of the financial reform law should strengthen competition and efficiency and improve prudential controls.

My Honduran authorities recognize that much needs to be done to consolidate the gains already achieved and to maintain the momentum of the structural adjustment process. For these reasons, they will be in close contact with the staff in order to design the second annual arrangement under the ESAF. They are ready to take additional measures to achieve the envisaged targets, and they hope to receive the continued support of the Board in their adjustment efforts.

Mr. Dawson made the following statement:

While it has taken some time, we are encouraged that this program has been patched back together sufficiently to permit completion of this review. Nevertheless, the adjustment effort has been set back somewhat by the policy slippages that have taken place, and the progress anticipated under this ESAF arrangement has not fully materialized. In view of the slippages and a revised external outlook suggesting that external viability is becoming more and more elusive, further strengthening of the adjustment effort--above and beyond the targets envisaged for 1993 under this arrangement--clearly seems to be in order.

Economic performance over the last year was mixed. There have been some positive developments since the previous review, as reflected in the strong 5.8 percent growth rate of the economy, the better than expected reduction in inflation to 6.5 percent, and the implementation of key structural reforms. Yet, considerable ground was given back as fiscal policy become expansionary; inflation subsequently increased to the present 14 percent, and the currency depreciated.

The authorities seem to see the dangers inherent in the current situation and appear committed to taking a number of corrective measures to put the program back on course. While we applaud their efforts, we question whether this will be enough to put the economy firmly on the path toward external viability that was envisioned in the original ESAF arrangement.

In our view, further strengthening of the adjustment effort is needed in view of the revised and unsettling projections for the balance of payments. For this year, the absence of a financing gap is dependent upon resolution of about $80 million in arrears. Furthermore, there could be adverse effects from lower than expected global commodity prices and higher than expected interest rates, both during the remainder of 1993 and on through the conclusion of the ESAF arrangement in 1995. Looking further out, substantial financing gaps--on the order of $100 million--are expected in 1996 and 1997; these gaps also may similarly be affected by exogenous developments. In sum, by the staff's estimates, Honduras appears to be moving away from, not toward, external viability in the medium term.

The difficult external outlook only underscores the need for a stronger adjustment effort that would encompass tighter financial policies and progress on the remaining items on the structural agenda. In this regard, we recognize that in the months that remain before the elections conditions may not be especially conducive to further progress. However, it would be a mistake to let the reform process stall, for delays now will only necessitate more difficult measures later on.

Like the staff, we are especially concerned by the stance of fiscal policy. The corrective measures under way or planned for the second half of 1993 will go far to correct the deviations from the program in the first half of the year, but, for the year as a whole, there will be little in the way of fiscal consolidation relative to 1992. There seems to be progress on increasing revenues, and the planned increase in capital spending seems justified in view of investment needs that have been postponed or delayed. However, as a proportion of GDP, current expenditures will fall by only 0.3 percent of GDP in 1993 and by 0.7 percent in 1994. We see considerable scope for additional reductions--beyond those incorporated in this program--through work force reductions in the civil service and in public enterprises, further reduction of subsidies, and increased private sector provision of public services such as power, water, and telecommunications.

The fiscal consolidation envisioned under the program would provide a boost to monetary policy by limiting demand for financing, but we agree with the staff that further monetary tightening is necessary to curb inflation. As to its implementation, it is unfortunate that policy slippages have forced the authorities to raise the already high reserve requirement to 42 percent, rather than lower it as envisioned at the previous review. It would be far preferable to utilize open market operations as the policy tool, especially in view of the 1992 reforms that made such operations possible. We would urge the authorities to take whatever further steps may be necessary to reduce their discomfort with open market operations. In this area, as well as for other aspects of central bank operations, such as monetary statistics and bank supervision, legislative changes would be helpful, as would technical assistance available from the Fund, to strengthen institutional capabilities.

A good deal of progress has been made on structural reforms, but we urge the Government to continue with its plans to achieve the 1994 targets of the original program. We see a particular need to open all sectors of the economy to newcomers, both domestic and foreign, to promote the diversification of the economy that is sorely needed in view of the diminished prospects for traditional exports. This will require major improvements in the domestic investment climate, including further opening for foreign investment, and reforms in the system of business taxes, the labor code, and the legal system.

As part of this effort, financial sector reform deserves special attention. We would like to see the authorities press ahead as planned to secure early passage of the delayed financial reform legislation. It would also be helpful to inject additional competition in the banking sector through institutions that are tied to neither the Government nor key economic interests.

To return quickly to the external sector, we welcome the exchange reforms that have been put in place and the planned elimination of the last remaining exchange-related measures on the agreed timetable. In this regard, we concur with the appropriate provisions of the proposed decision. We strongly agree with the staff that removal of the import surcharge should not be delayed any further. Finally, we are disappointed that, like other countries in the region, Honduras's export prospects are limited by the EC's discriminatory barriers to "dollar bananas," and would again urge the members of the EC to remove these barriers to trade.

Despite these concerns, we can support the proposed decisions and the necessary waivers for the performance criteria missed in December 1992. We hope the authorities move rapidly to put in place an ambitious second-year arrangement that would represent a more substantial return toward medium-term external viability.

Mr. Jaramillo made the following statement:

During 1992, the Honduran economy performed well with respect to both growth and inflation. The balance of payments, notwithstanding the unfavorable circumstances faced by the country's external sector, ended the year with a moderate surplus. There were, however, slippages in the fiscal front that set the authorities' program temporarily off track.

The nonobservance of several performance criteria basically had its origin in a more rapid than planned pace of execution of infrastructure investment. Furthermore, effects of terms of trade changes indirectly affect the fiscal performance and are difficult to compensate for rapidly. As evidenced by the good inflation and growth performance during 1992, the departures from the original adjustment path should not prove unmanageable if, as we are informed, the authorities undertake to regain their adjustment momentum during 1993.

The recent measures described in the statement by the staff representative, as a result of which the authorities have introduced all prior actions incorporated in the revised fiscal program, provide assurances of the Government's continued commitment to the adjustment effort. These measures, coupled with the expenditure reduction programmed for the second half of this year, should yield a fiscal improvement equivalent to about 3 percentage points of GDP. By next year, fiscal aspects of the program should be back on their original path. With these facts in mind, we can support the Honduran authorities' request for a waiver regarding certain quantitative targets within their economic program currently supported by an ESAF arrangement with the Fund.

The Honduran authorities have done well in completing most of the structural reforms contained in the first annual ESAF arrangement. In the context of carrying forward the momentum created by these accomplishments, effort is required in the consolidation of public finances with regard to establishing a more transparent fiscal policy stance, ensuring consistency with monetary and exchange rate policies. We view this as necessary for the adequate implementation of planned financial sector reform.

The tightening of monetary policy through the increase in commercial banks' reserve requirements produces market distortions that must be weighed against the effectiveness of this tool as a monetary instrument. Over the medium term, in view of the adverse resource-allocation effects of very high reserve requirements, the shift toward more market-oriented monetary policy instruments should prove more congruous with the authorities' objective of deepening structural reform. Insofar as one of the medium-term issues is to strengthen the authorities' ability to restore exchange rate market stability when confidence in the lempira weakens, adoption of indirect monetary instruments should help to make market pressures more apparent, thus complementing the efficacy of the policy response.

We welcome the submission of the draft financial sector reform law to Congress as a visible component of the authorities' commitment to maintain their structural adjustment effort. We encourage the prompt implementation of this law, which should not only diminish the possibilities of recurrent crisis in the foreign exchange market, but should also contribute decidedly to a more transparent and efficient allocation of credit resources within an environment of diminished risk made possible by enhanced prudential regulation. Over time, a better functioning financial system should also favor the country's growth prospects.

Honduras' medium-term balance of payments remains fragile. Stability in the exchange market, maintained through judicious central bank market intervention to smooth out sharp short-run fluctuations and consolidated by the Government's continued commitment to fiscal prudence, should lay the groundwork for a further strengthening of nontraditional exports over time. Such a development would reduce Honduras' dependence on its two basic primary exports, whose extremely volatile markets transmit their instability to other sectors in the economy. The recent exchange rate behavior described in the statement by the staff representative is a sign that the exchange market is, in fact, stabilizing. It seems clear, however, that the capital account will have to continue to provide significant surpluses for some time to come, both through the support of the international community and through private inflows that should continue if prudent financial policies are maintained.

Regarding this last point, the presence of large private capital inflows is a welcome sign, as it is an indication that policies are broadly on the right track. Achieving the conversion of capital inflows into physical investment should now be a prime objective to be pursued by the authorities. As regards the financing of public sector investment, the success of recent debt refinancing should free resources for further growth in public savings, allowing the maintenance of investment in public infrastructure to continue without undue pressures on the country's external indebtedness. Furthermore, given the economy's sensitivity to changes in the terms of trade and to variations in foreign interest rates, it is true that adherence to fiscal prudence must remain a paramount objective. However, it is also crucial that the authorities continue to obtain the exceptional external financing envisaged in the program. Its presence will facilitate the continuance of the country's social programs without exerting undue pressures on the balance of payments.

Finally, we support the proposed decisions.

Mr. Posthumus made the following statement:

Last year, in our discussion on the first-year ESAF arrangement for Honduras, I noted the weakness of the fiscal side of the program and warned that there would be a need for the authorities to resist pressures to increase expenditures. I also found it disappointing that the deficit was expected to increase by 1 percentage point of GDP in 1992; in the event, the deficit increased by 1.5 percentage points compared with 1991, even without elections. Thus, 1992 showed a deficit of 4.8 percent of GDP, lower than 1990 but higher than the 3.3 percent of GDP in 1991. This year again, it seems, a deterioration must be feared. The fiscal position in the first half of 1993 has increased to 6 percent of GDP.

The authorities and staff agree that the objective should be to get the program back on track. This requires that the fiscal deficit for the full year of 1993 be reduced to 3.8 percent of GDP, which in turn means reducing the fiscal deficit for the second half of 1993 to about 2 percent of GDP--a very substantial reduction to be achieved in a very short period. I appreciate the actions taken by the authorities to raise revenues and reduce expenditures. The staff and Mr. Marino do not, however, make it clear to what extent the measures taken will actually reduce the deficit in 1993. I am concerned about the likelihood of the scaling down of capital expenditures and about what the staff notes is the temporary nature of some of the revenue measures.

I read in the staff appraisal that the reduction in the domestic borrowing requirement of the public sector in 1993 is a key element in reducing inflation and, among other objectives, stabilizing the exchange rate. It is obvious that if the envisaged fiscal deficit for the second half of 1993 is not achieved, the domestic borrowing requirement will be higher and neither the inflation nor the exchange rate objectives cited by the staff would be achieved. Such an outcome would mean an even heavier burden of adjustment in 1994, for instance, continued postponement and scaling down of capital expenditures in addition to the revenue measures envisaged.

Even with the achievement of the program's objectives, financing the balance of payments deficit in 1993 will require substantive debt and arrears rescheduling and cancellation and would still leave a gap of $82 million, which is to be covered by further rescheduling of debt and arrears with bilateral creditors. Given this situation, I think there is a need to know what the probability is of Honduras reaching agreement on the rescheduling of this $82 million with its creditors and, in the event that no agreement is reached, what actions are available and contemplated by the authorities to meet this financing gap. The financing assurances in both the short term and the longer term seem to be drifting away.

Let me make one more point with respect to monetary policy. I note and welcome the intention of the authorities to reduce rediscounting operations funded with domestic resources. I would urge them to proceed with the complete elimination of such operations, as these represent in effect a form of credit allocation by the Government, which is inconsistent with the determination of credit allocation and interest rates by the market.

Finally, as a more general remark, it is true that the efforts of the Honduran authorities are commendable and that much progress has been made with both stabilization and reform. Today's delayed review, the insufficient measures taken to put the program on track, the request for a waiver for the nonobservance of four performance criteria, and the already announced intentions that the program may have to be strengthened worry me greatly. The Fund should strengthen the hand of the authorities, and Fund-supported programs should inspire creditors and donors to provide the required financing. I doubt that this program fulfills these functions.

The Chairman noted that Mr. Posthumus, in concluding, had touched on a very important point, with which he agreed completely. In a number of recent cases, such as Belarus and Kazakhstan, the adoption of a Fund-supported program had not attracted a favorable response from the international community. The Fund had reached a difficult juncture. There was an impression that multilateral institutions were being asked to fulfill their traditional role, but that bilateral, complementary support was not always made available in time, which was a matter of great concern.

The staff representative from the Western Hemisphere Department said that, as he had noted in his introductory statement, the authorities had already taken all the prior actions that were envisaged in the economic program. On the revenue side, those measures included adoption of the asset revaluation tax, the adjustment of the customs valuation factor, and the reduction in subsidies; in addition, during the recent mission, it had become clear that certain taxes, such as income taxes, were performing better than expected. Consequently, there was also a reasonable assurance that the revenue targets would be met. On the expenditure side, the envisaged reduction in investment had already been implemented by the electricity company, and there was also a reasonable assurance that the expenditure target would be met.

The remaining external financing gap was linked fundamentally to the elimination of arrears to certain Central American countries, the staff representative remarked. The Honduran authorities had been in contact with those countries for some time, and they had indicated to the staff that they were hopeful that rescheduling agreements could be concluded in a manner consistent with the terms of Paris Club agreement.

Mr. Posthumus said that while it was true that the statement by the staff representative mentioned a number of revenue actions, that statement also indicated that some of them would be effective only as of January 1, 1994. Consequently, as those measures would not generate any revenue in 1993, it was not clear to him that the revenue target for 1993 could be met.

On the relationship between Fund support and bilateral support for countries implementing adjustment programs, Mr. Posthumus continued, he agreed with the Chairman that there was a danger of a shortfall of foreign financing in several cases. In the present case, however, he had stressed the fact that an important role in obtaining financing by any country was the strength of its adjustment efforts. It was important not to forget that part of the equation, as there was often a great difference in the efforts of individual countries.

The staff representative from the Western Hemisphere Department stated that, on the basis of available information, the fiscal measures that the staff and the authorities had agreed for 1993 would be sufficient to keep the fiscal deficit within the agreed limit. At the same time, however, the staff had wanted to give the Board a reasonable assurance that the targets for 1994 would also be met, which was why it had asked the authorities to identify, and even adopt, measures that would help to achieve the fiscal target for 1994. Of course, as had been pointed out, certain measures would not take effect until January 1994, such as the elimination of remaining subsidies for fuel products.

The staff representative from the Policy Development and Review Department said that the staff had been working with the authorities on other revenue reforms that required legislative action. Some of those measures were directed toward ensuring that, even if there were delays in implementing other measures, the revenue that had already been identified would be secured. When supported by other permanent reforms, the temporary revenue measures would eventually provide a better basis for the future.

Mr. Dorrington made the following statement:

It is a matter of great concern that Honduras has missed so many performance criteria. This is particularly worrying as it is not possible to claim that these slippages have been due to exogenous shocks; rather, Honduras decided to breach its agreement with the Fund.

I accept that some relative comfort can be drawn from the fact that most of the slippage was related to capital rather than current expenditure; in my view, it is appropriate that capital expenditure must bear a substantial part of the burden of adjustment. However, I would welcome staff comments on the extent to which this extra spending has enhanced productive potential and net exports.

In these circumstances, the staff was unambiguously right not to bring the midterm review to the Board on the original timetable. The staff was also correct in waiting to bring this review and request for waivers to the Board until it had obtained the commitments listed in the staff report--commitments that, we are told, should bring performance back to the path that was originally envisaged; in this context, the comments of Mr. Dawson and Mr. Posthumus are relevant.

Nevertheless, the question must now be asked whether, given the nature and extent of the slippages, we can have any confidence that the new commitments will in fact be adhered to. I am sure that the staff will have spent some considerable time asking itself precisely that question. The fact that an election is to be held in a few months, and that it was to a large extent pre-election pressures that led to the recent slippages, makes one skeptical. But those same pressures will have made it difficult for the authorities to agree to the amended program and to the prior actions mentioned on page 8 of the staff report. I would certainly prefer actions now that have effects in 1994 to the alternative of not having any actions at all. The fact that the authorities have already taken some difficult decisions helps considerably in trying to give Honduras the benefit of the doubt as to whether the authorities will have the commitment to take other difficult decisions that must lie ahead.

If the Fund's support for Honduras had been in the form of a stand-by arrangement, I would have been arguing for an extension of, and a rephasing of purchases under, the arrangement. But I understand that this is not an option under a first-year ESAF arrangement. Instead, we have to choose between a rock and a hard place, and neither is a very attractive proposition. This is an issue that should be addressed in the context of the design of an ESAF successor.

Meanwhile, the decision as to whether we give Honduras the benefit of the doubt--the very considerable doubt--is a finely balanced one. If we do give Honduras the benefit of the doubt, then I hope our trust, and that of the staff, will be rewarded by Honduras sticking precisely to its new agreement; the consequences for Honduras of not doing so are severe.

In the circumstances, I think that the Board should be kept informed of progress under the ESAF arrangement, without waiting for the next regular review of country matters in the event of any major developments. In particular, we should be informed as soon as possible whether the September benchmarks have been met, and I would welcome staff comments on that point.

Mr. Fridriksson made the following statement:

The outlook for the Honduran economy has deteriorated since the ESAF arrangement was adopted a year ago. In the first half of this year, the public sector deficit, which had been on a declining trend since the late 1980s, continued its rise initiated in 1992, inflationary pressures re-emerged, net international reserves declined, and the currency depreciated rapidly. Furthermore, the medium-term balance of payments prospects are now considerably worse than a year ago. At that time, it was expected that Honduras would have virtually no need for exceptional financing in the medium term. Now, the projection shows a substantial financing gap increasing to $95 million a year after 1995.

In view of these developments, the public finances need to be substantially strengthened. The fiscal policy slippages in 1992 were mainly on the expenditure side. Public investments, in particular, expanded significantly. Recognizing these problems, the Honduran authorities have put forward a revised fiscal program aimed at reducing the fiscal deficit in the current year and to reaching 2 percent of GDP next year, comprising both revenue and expenditure measures.

I welcome this revised program, but the Honduran authorities should be in no doubt that successful, full implementation of the announced fiscal tightening is absolutely crucial in order to address the mounting medium-term problems facing the economy. Pressures on fiscal policy are likely to emerge later this year, but they must be resisted.

On monetary policy, I note the need to achieve greater efficiency in the open market operations of the Central Bank in order to ease the burden on the reserve requirement instrument, which squeezes the profitability of the already fragile banking system. If inflationary pressures continue to build up, monetary policy will need to be tightened further. With reserve requirements already high, and having been increased by a further 7 percentage points in July, this instrument appears to be seriously overburdened, and it is therefore crucial to rapidly increase the efficiency of the financial system.

Under the current ESAF arrangement, several performance criteria were missed at the end of last year. This is highly regrettable, inasmuch as many of the overruns were related to the fiscal policy slippage that occurred in 1992. However, the overruns were also to some extent fueled by the large private capital inflows experienced by Honduras in 1992, as in several other developing countries. In view of the firmer monetary policy and plans to tighten fiscal policy, and in the expectation that the revised fiscal program will be fully implemented, I support the request for waivers for the nonobservance of a number of performance criteria for end-December 1992, and the completion of the midterm review under the first annual ESAF arrangement.

I would nevertheless strongly urge the authorities not only to steadfastly implement their policies in the second half of this year, but also to seek to strengthen in particular the fiscal adjustment effort in the next program year. This appears to be absolutely essential, in light of the worsened balance of payments outlook and the vulnerability of the external side, if Honduras is to achieve medium-term viability. Stronger adjustment effort in the medium term than envisaged when the ESAF arrangement was originally planned is, in my view, required, and that need should guide program design for next year. The need for such action is underscored by the prospective external financing gaps, as has been clearly emphasized by Mr. Posthumus and Mr. Dorrington.

Mr. Quattrociocche made the following statement:

The performance of the Honduran economy under the ESAF arrangement does not leave much room for complacency so far. A number of performance criteria have been missed, and it is clearly necessary that Honduras take urgent steps to correct its financial imbalances and to reduce inflation. In fact, during the first months of the present arrangement, the authorities seemed unable to maintain the degree of financial restraint necessary to hold the program fully on track. The measures envisaged to make up for the slippages that occurred thus far do not seem overambitious, and even their prompt and full implementation will only help pave the way for much-needed bolder action.

This chair can only hesitantly go along with the proposed decisions, as we are not fully convinced, by reading the staff report, that the deviations from the performance criteria set in the program are of a minor and temporary nature so as to justify the authorities' request for waivers. In the coming months, Honduras should make significant efforts to strengthen its economic program along the lines suggested by the staff in order to bring it back on track. I fully share the concerns expressed by previous speakers, and I only wish to underline a couple of points.

Fiscal performance was particularly weak. As a result, in the absence of corrective measures, the fiscal deficit for 1993 will be of the order of 7.5 percent of GDP--that is, three times as large as the original program limit. Moreover, even assuming full compliance with the revised fiscal program, the fiscal deficit for 1993 will still amount to 3.8 percent of GDP, as against the 2.5 percent target set under the program. The budget for the current fiscal year shows that despite the prospective adoption of some measures, both revenues and expenditures as a ratio of GDP will remain broadly unchanged relative to last year's figures. In this connection, I fully share the assessment of the staff that the major concerns arise in the field of current expenditure, and I was struck by reading that under the revised fiscal plan, current expenditure is to be reduced by only 0.2 percent of GDP--a point already stressed by Mr. Dawson. I would be glad to hear from the staff what prevented the authorities from effecting more substantial expenditure cuts. Controlling the budget is a crucial precondition for the attainment of macroeconomic stabilization and the easing of inflationary pressures, which has to be pursued not just through piecemeal solutions, but rather through a much more aggressive stance. Unfortunately, I could not find any indication of a sizable reduction of current expenditure in the authorities' letter of intent either, and once again I wonder whether the staff can shed some light on this regrettable choice.

My second point has to do with the external side of the program. The large financing gaps expected to persist over the medium term, in the face of the program policies and taking account of possible debt rescheduling, seem to suggest that the financial package envisaged in the present arrangement might not be strong enough to resettle the Honduran economy on a path of financial stability and sustainable growth. The strongest commitment on the part of the authorities to keep their program on track will therefore be a minimum condition to give their adjustment effort enough chances of success. Also, given Honduras' less than exceptional payments record, it is of the utmost importance that, in order to maintain a sustainable debt-service ratio over the medium term, the authorities observe strict limits on the contracting of nonconcessional medium- and long-term obligations by the public sector.

With these comments, I support the proposed decisions.

Mr. Ishida made the following statement:

It is worrisome that a number of performance criteria were not met in 1992, even though the major reason can be regarded as the larger than expected GDP growth. The authorities should be aware of the vital importance of meeting the performance criteria of the ESAF arrangement. I am disappointed that the authorities' efforts in implementing structural reform have not been sufficient.

However, I welcome the fact that GDP grew by 5 percent in 1992, which is above the program estimate, that the inflation rate was about half of the projected rate, and that the external current account deficit was kept at the same level as in 1991 despite the fall in the price of coffee and the EC's import restrictions on bananas.

I strongly hope that the authorities will be able to resume discipline, particularly in the fiscal area, and I would like to continue to support the authorities' efforts under the ESAF arrangement.

I would like to make some comments on the program for the second half of 1993.

On the fiscal front, I agree with the staff that the authorities should reduce the overall budget deficit in order to avoid high inflation and strengthen the external position. However, I can understand that the authorities have found it necessary to adopt a policy that is intended to increase infrastructure investment through a current account surplus. If the authorities cut infrastructure investment simply because the growth rate of expenditure is high, I would be concerned.

Turning to monetary policy, I would recommend that the authorities continue to tighten monetary policy in response to the rapid expansion of credit in 1992 and in the first half of 1993.

The stabilization of the exchange rate of the lempira is crucial for the future of Honduras' economy. An extreme depreciation of the lempira would be dangerous in terms of rising inflation. It is necessary to stabilize the exchange rate as soon as possible. For this purpose, the authorities should be encouraged to make the foreign exchange market more active, and they need to avoid slippage in the implementation of fiscal and monetary policies in order to maintain the credibility of the lempira.

With respect to capital inflows, I note that direct investment, which was larger in 1992 than in the previous year, contributed to an improvement in the capital account. I would like to encourage the authorities to recognize the importance of direct investment and to make efforts to promote it.

Lastly, I would like the authorities to firmly keep the commitment to eliminate the remaining arrears by the end of 1993.

Mr. Blome made the following statement:

I regret the policy slippages caused by the surge in public investment, which have led to the nonobservance of several performance criteria and have contributed to a rise in inflation and a rapid depreciation of the exchange rate in the last few months. This performance is especially disappointing when viewed against the background of the slippages that occurred in earlier programs. The deteriorated balance of payments outlook, although partly based on exogenous factors beyond the authorities' control, is another cause for concern. I thus agree with previous speakers that there is an urgent need to bring fiscal policy back on track. The fact that 1993 is an election year must not lead to a postponement of necessary adjustment measures.

Having said this, I welcome, in principle, the fact that the authorities have adopted a revised fiscal program in late May, when the deterioration of the economic situation started to accelerate. The envisaged measures of this revised program, in particular the planned reduction of the fiscal deficit from about 6 percent of GDP in the first half of 1993 to 2 percent of GDP in the second half, are certainly important steps in the right direction. Nevertheless, I wonder whether this program is ambitious enough under the present circumstances and whether the planned measures are appropriate.

Concerning the program for the second half of 1993, I note that the planned revenue measures are, to some extent, of a temporary nature and will hardly strengthen the Central Government's revenues on a permanent basis. In addition, the planned reduction of capital expenditure is to be achieved partly by a postponement of projects, which might burden the budgets of future years. Moreover, despite these reductions, capital expenditure will still exceed the original program ceiling of 7.6 percent of GDP by a margin of about 0.7 percent of GDP. I also note that the envisaged cuts in current expenditure--equivalent to 0.2 percent of GDP--are very modest. To sum up, I feel that the program for the second half of 1993 relies somewhat too heavily on revenue measures of a temporary nature and that more far-reaching savings in both current and capital expenditure might be attainable. While conceding that a further strengthening of this year's program might be difficult to carry through, I would like to emphasize that this program must at least be strictly implemented and that there is no room for any further slippages.

Concerning the program for 1994, I welcome the objective to further reduce the fiscal deficit to the original program limit as another important step. However, in view of deteriorated balance of payments prospects and the increased external vulnerability, I share the staff's view that stronger adjustment efforts over the medium term than originally envisaged under the ESAF arrangement may well be required. In this context, let me underline that sufficient progress toward balance of payments viability is an essential precondition for an ESAF arrangement. It is very probable that this precondition can only be met in the case of Honduras if adjustment policies are further strengthened in the coming years.

I thus wonder whether the authorities should not set themselves more ambitious goals for 1994. The present fiscal projections for 1994 leave ample room for further savings in my view. I note, for example, that expenditures for wages and social security will continue to rise strongly by another 12 percent, while the inflation rate is projected to decline to an annual average of 6.6 percent. In February 1992, this chair expressed its concern about the substantial spending overruns with regard to the wage bill and the delays concerning the planned reduction of employment in the public sector. This criticism could also hold true for 1993 and 1994. In addition, I note that the ratio of revenue to GDP will remain at the same relatively low level next year as in 1992 and 1993, namely, 17.3 percent. The authorities should therefore consider further measures to improve tax administration. There may also be some room for maneuver for a limited rise in direct tax rates as a supplement to the planned increase in indirect taxes. By measures like these, a further strengthening of the fiscal position might be attainable.

On monetary policy, I would first underline the staff's view that monetary policy would need to be tightened further if inflationary pressures continue or if additional pressures in the exchange market were to develop. Second, I would like to comment on the plans to expand the scope of open market operations in order to allow for an eventual reduction of the high level of legal reserve requirements. Here, I would caution against relying too heavily on open market operations in order to sterilize excess liquidity, because such operation could additionally burden Central Bank finances, thereby making its planned recapitalization more difficult. Moreover, I do not think that the high legal reserve requirements are the sole reason for the large spreads between deposit and lending rates of commercial banks. Further structural reforms with the aim of increasing competition in the banking sector would probably lead to a reduction of these spreads. It is regrettable, in this context, that the important financial sector reform law has not been implemented so far.

With regard to structural reforms in other areas, I would stress the need to strictly implement all envisaged measures in order to improve the efficiency of the economy, but also to ensure the timely disbursement of program loans from the multilateral institutions, which are necessary to close the widening financing gaps. I would also encourage the authorities, in this context, to consider a restructuring of the public sector, including privatization of some public enterprises such as the Honduran telecommunications agency. At present, the public sector, consisting of central and local governments, decentralized institutions, and some important public enterprises, seems to be rather extensive; a streamlining of this sector might thus be appropriate.

With these observations, I support the proposed decisions.

Mr. Desruelle made the following statement:

Like some previous speakers, in particular Mr. Jaramillo, I first wish to point out the significant efforts made by the Honduran authorities and the positive results achieved in the past year. Among these results, I would include, of course, the growth performance--5 percent compared with a programmed rate of 3.5 percent--the decline in inflation in 1992 to 6.5 percent compared with a programmed level of 12 percent, large increases in gross domestic investment and gross national savings, and the resilience of the current account in the face of the decline in the prices of traditional exports. As to the reform efforts, I would particularly note the structural reforms in the monetary field and liberalization of external trade and of the foreign exchange regime.

Nevertheless, challenges remain. This is made clear by the slippages in the implementation of the program, particularly in the fiscal area, as well as by the evolution of the macroeconomic situation marked by a high rate of growth of private sector credit, increasing inflation during some months, rather rapid depreciation of the exchange rate, and the ongoing difficult external situation.

In this context, the measures that have been taken recently by the authorities are extremely encouraging, as they address the concerns raised by the recent economic performance in the fiscal, monetary, and external areas. The revised fiscal plan is most welcome. It is balanced between an increase in public savings and a reduction in capital expenditures from the earlier budgeted level, and should help achieve a significant reduction in the fiscal deficit. Coupled with the envisaged external financing, this reduction should, in turn, allow a reduction in the net domestic borrowing requirement of the public sector.

The measures taken on the monetary side, namely, the increase in the reserve requirements, the reduction in the rediscount lines, and the intention to conduct a significant amount of open market operations, should, in addition to the reduction in the public sector domestic borrowing requirement, help contain the rate of growth of the banking system's liabilities, and so help in the reduction of inflation.

The combined fiscal and monetary measures should also permit a strengthening of the current account position. Even though one should not probably make too much of movement in the exchange rate from one month to the next, the recent appreciation of the exchange rate can be seen as a first sign of renewed confidence in the authorities' economic program.

After these general remarks, let me make a few specific comments on fiscal and monetary policies and on external developments.

Let me start with fiscal policy. First, the staff report makes quite clear that the slippages in 1992 were due to the increase in capital expenditures. For instance, while the limit on central government expenditures was exceeded by 1.1 percent of GDP, capital expenditures of the Central Government expanded by 1.7 percent of GDP; and while, overall, the net domestic financing requirement increased by 2.4 percent of GDP, capital expenditures of both the Government and public enterprises increased by 3.4 percent of GDP. Second, capital expenditures appear to be concentrated on essential infrastructure projects such as roads, telecommunications, and electricity generation. Third, the revised program had to make a difficult choice between the need for these capital expenditures and the necessity of reducing the public deficit and its domestic financing.

This highlights the importance of containing current expenditures and protecting the tax base to permit the desired level of capital expenditures, which are certainly needed in the case of Honduras. In this respect, the measures that have already been taken to consolidate the revenue base after 1993 are most welcome.

One may wonder whether increased private sector participation in infrastructure projects could help achieve the goals of fiscal consolidation and adequate capital expenditures. I note that the staff report mentions private sector participation in electricity generation. I would welcome comments from the staff on further measures that could be considered to increase participation of the private sector in infrastructure projects.

Turning to monetary policy, measures already taken to tighten monetary policy are, as I have said, welcome. One source of concern regarding the efficiency of the banking sector is due to the high level of obligatory reserves and the ensuing high spread between lending and borrowing rates. To remedy this situation, the staff suggests increased use of open market operations. However, there seems to be some hesitation on the part of the authorities regarding increased use of open market operations, hesitation linked both to institutional considerations and more pragmatic concerns. In this respect, technical assistance from the Fund will certainly be extremely helpful. Furthermore, the planned reform of the financial system aimed at reinforcing its supervision should make the financial system stronger and, thus, facilitate the conduct of a monetary policy based on indirect instruments. It is hoped that, in the medium term, with both better supervision and technical assistance, it will be possible to make increased use of open market operations.

Finally, a few words on the external sector. As previous speakers noted, there remains an important need for external financing over the coming years. In this respect, I welcome the information given by the staff at the beginning of this meeting on the elimination of the financing gap in 1993. The need for external financing clearly indicates the importance of strictly adhering to the 1993 fiscal program and the target set for 1994 for further reducing the public sector deficit.

In conclusion, given the commitment shown by the authorities to the program with the measures recently implemented and the number of prior actions taken, I certainly agree to the waivers and I support the proposed decisions.

Mr. Lee made the following statement:

Under a medium-term economic program for 1992-95, the authorities' performance in 1992 was partly successful. Strong economic growth continued, inflation declined sharply, and structural reforms have been extended. However, the fiscal position has weakened, and a number of the program's performance criteria were not observed as a result. The fiscal deterioration continued into 1993, and inflation began to increase.

In these circumstances, I am pleased to see that the authorities recently adopted a revised fiscal program in order to reduce substantially the fiscal deficit in 1993 and bring it back on track in 1994. However, it is most important that the authorities be strongly committed to the revised program and fully implement the planned measures. Especially in an election year, the authorities will need added efforts to resist expenditure pressures. Fiscal actions for 1993 are expected to reduce the fiscal deficit substantially, but they included temporary measures. In light of the recent deteriorating tax base, I encourage the authorities to adhere to the planned measures for 1994, which are intended to broaden the revenue base on a more permanent basis.

On monetary policy, the authorities introduced in 1992 a system of government paper auctions with an objective of developing open market operations. However, the authorities have engaged in only limited open market operations and had to maintain the high legal reserve requirements, contributing to large spreads between deposit and lending rates. While I agree with the authorities that it would take some time for open market operations to become effective, I would encourage the authorities to strengthen the role of open market operations in the conduct of monetary policy. In this respect, I welcome the authorities' intention to move forward with the recommendations of a recent Fund mission.

The balance of payments for 1993 is projected to be more difficult than that for 1992. This should require the authorities to further strengthen the public finances and accelerate structural adjustments. Furthermore, Honduras is very vulnerable to the external environment, as indicated by the staff's sensitivity analysis. Therefore, the authorities need to renew their commitment to full implementation of the revised program. In addition, they should be prepared to take additional measures if and when the external environment is not in their favor.

With these remarks, I support the proposed decisions.

Mr. Kural made the following statement:

There are three major potential obstacles to the implementation of Honduras' program: first, Honduras' public savings rate, which is too low to finance an increase in public investment; second, Honduras' very fragile fiscal and balance of payments situation; and third, Honduras' vulnerability to external shocks.

Given the risk that the 1993 election will cause fiscal policy slippages, the weakened public sector savings is the most serious constraint. It is doubtful that structural reform can boost the effects of existing investment enough to produce a growth rate of about 4 percent. The present mix of public and private investment cannot meet the need to restore the country's social infrastructure. Even if the 1993 public savings target is met, this would probably not suffice to meet the country's investment needs, and additional measures must be considered. To keep fiscal policy on track, it will be crucial to firmly implement the agreed expenditure policies, especially as regards reducing subsidies and transfers and broadening the base of the sales tax.

The third problem is the vulnerability of Honduras' exports, which are very sensitive to the prices of coffee and bananas. Last year, despite the sharp decline in the prices of its main export commodities, Honduras showed improved resistance and has succeeded in developing exports in nontraditional sectors. This is food for thought, because it seems easy to overestimate the importance of the exchange rate and to underestimate the importance of structural changes in terms of their balance of payments effects.

In ending, let me express the hope that the Honduran authorities can maintain an appropriate balance between progress with structural adjustment and maintenance of macroeconomic policies. I encourage the authorities to act promptly and firmly in dealing with their very difficult fiscal situation and to press forward with liberalization and the adoption of market mechanisms.

With these remarks, I support the proposed decisions.

Ms. Lindsay-Nanton made the following statement:

As earlier speakers have noted, the Honduran authorities have made good progress in reducing imbalances since the adoption of their comprehensive stabilization and structural reform program in 1990.

In the face of weaker prices for Honduras' main export commodities, in 1992 real GDP grew by 5 percent, inflation declined sharply, and implementation of structural reforms deepened. The authorities must be commended for these achievements. On the downside, however, the fiscal position weakened and the staff notes that more recently inflation has started to increase and confidence has weakened. I wish to make two observations.

The first relates to fiscal policy. The authorities are correct in viewing further strengthening of the public finances as the cornerstone of their economic program. While it is clear that the combined current account surplus of the Central Government and the main public enterprises rose by some 0.3 percent of GDP in 1992 over 1991, as the staff points out, the overall deficit increased by 2.4 percent of GDP on account of larger than envisaged public sector investment.

Indeed, the staff points to the benefits of improvements in basic infrastructure, but it is clear that if further improvements are to occur, the authorities will have to increase public sector savings significantly. In addition, the weaker medium-term balance of payment outlook, as suggested by the staff, makes this even more crucial.

In this context, therefore, I welcome the prior actions taken in 1993 aimed at further fiscal consolidation. However, I must admit that I am not completely at ease with this area. I note what the staff said at the beginning of the meeting, but the list of revenue measures appears to be a rather ad hoc combination of instruments thrown together in 1993. This observation seems to be borne out by the staff's reference to the "temporary nature, to some extent" of these measures, as against the "more permanent" ones planned for implementation in 1994. Notwithstanding the staff's explanation, I question the feasibility of the 1994 fiscal targets. In addition, perhaps the staff could also comment on what scope there may be for a comprehensive review of taxation aimed at streamlining and improving the coherence of the fiscal system.

My second comment relates to the external sector and the fragility and vulnerability of the balance of payments. Coming from a small island economy, one knows only too well the instability that can be created by external shocks. Indeed, the staff demonstrates that there will be significant effects if adverse changes in the terms of trade and higher foreign interest rates were to take place. Hence, in addition to further strengthening of the public finances, speeding up implementation of structural reforms will be crucial if private sector investment is to increase and resources are to be allocated more efficiently.

This being said, I observe that nontraditional exports are expected to continue to grow rapidly over the medium term, but at a rate below that of the average annual rate observed in 1991-92. I would be grateful for the staff's comments on whether there exists scope for stronger growth in nontraditional exports and, if there are constraints in this sector, how in fact they might be eliminated.

I support the proposed decisions, including the request for waivers for nonobservance of certain performance criteria.

The staff representative from the Western Hemisphere Department said that investment in 1992 had largely been directed toward telecommunications, financed mostly with domestic resources, energy generation, and roads financed by the multilateral institutions, and, to a smaller degree, water supply. Clearly, by improving infrastructure, such investment had an impact on Honduras' export potential, particularly as some of the improvements in infrastructure had taken place in a region where there was rapid growth of nontraditional exports. Nontraditional exports had increased very rapidly over the previous two years at a rate in excess of 12-14 percent. The staff's projections assumed that they would continue to grow somewhat rapidly, averaging about 10 percent.

With respect to the mix between current and investment expenditure, the authorities felt that at present they could do no more than achieve a fairly small reduction in current expenditure, the staff representative continued. The issue was under discussion, however, and the staff had identified some potential areas for further cuts in current expenditure. In the area of the wage bill, there was probably a need to both reduce employment and restructure wages. In the area of transfers, the staff was discussing with the authorities ways to reduce transportation subsidies. In addition, there would be a further reduction in current spending in 1994 following the discontinuation of the temporary coffee subsidy that was introduced in 1993; the subsidy was actually a loan to coffee producers, but the staff had classified the loan as current expenditure.

There was already some private sector participation in electricity generation, the staff representative noted. Beyond that, there was scope for private sector participation in the electricity sector and, potentially, in water supply.

In August, the staff would assist the authorities in conducting a comprehensive review of the tax system with a view to harmonizing it with those of other Central American countries, the staff representative from the Western Hemisphere Department remarked. Such a review would probably reveal a need to increase the scope of the sales tax, both by expanding the tax base through the incorporation of services and by increasing tax rates.

Mr. Dorrington said that he hoped that Directors would be kept informed of any significant developments, particularly with regard to the September 1993 benchmarks, in a more timely manner than was normal in most cases.

The staff representative from the Policy Development and Review Department said that the staff was, indeed, keeping Honduras' program under close review, and it would ensure that the Board was kept well informed.

The Chairman suggested that the pre-Annual Meetings informal meeting on country matters would be a good opportunity to review the latest developments, although full data on the September benchmarks would not be available until much later.

Mr. Marino commented that reaching the point at which the present review could be completed had been a long and difficult process. In part, the difficulty was a reflection of the ambitious nature of the authorities' program, which in a sense had been yielding satisfactory results. There was no doubt that the authorities remained firmly committed to the goals established in the 1992 policy framework paper. Moreover, they realized that there was a paramount need for a stable macroeconomic environment, without which they could not advance the fight against poverty, and that they needed to increase public sector efficiency and stimulate private sector development, none of which would be possible without adequate fiscal consolidation.

Undoubtedly, 1993 would be a difficult year for Honduras, given the pressures and problems that had surfaced during the last year of the outgoing administration, Mr. Marino said. Nevertheless, there were very encouraging signs of the commitment of the Government to preserve a stable macroeconomic environment, namely, the implementation of prior actions that had made possible the completion of the present review and that would substantially reduce the fiscal deficit in the second half of 1992. There had been some doubt whether those measures were sufficient, but the recent measures to improve tax administration would also contribute to the success of the program, although it was difficult to quantify their impact. All of those measures attested to the authorities' political will to adhere to the medium-term strategy envisaged in the ESAF arrangement, which was especially crucial in light of Honduras' reliance on external sources of finance. It was his understanding that both presidential candidates had indicated that the upcoming elections should not be allowed to delay progress in areas such as public sector reform and education sector modernization, while vigorously pursuing the medium-term fiscal consolidation goals of the program.

The importance for Honduras of the present review could not be underestimated, because it would unlock a substantial amount of financial resources that would help to underpin the country's transformation effort, Mr. Marino stated. In that context, he welcomed the Chairman's comments on the Fund's approach, which dictated that the Fund should sometimes shoulder more of the risk in supporting the efforts of not only traditional users of Fund resources but also many other countries. Most important, however, the present review would give Honduras the policies and measures to put financial discipline and structural reform back on track. It was true that the balance of payments was dependent on concessional support provided by the international community, but that fragility constituted both an incentive for the Honduran Government and a guarantee that the Government would maintain the proposed adjustment path. Of course, on its part, the international community should maintain open markets. He welcomed the comments of Mr. Dawson and Ms. Lindsay-Nanton in that regard, and he hoped that the issue of banana imports into the EC would be resolved favorably.

The Chairman made the following summing up:

Executive Directors generally agreed with the thrust of the appraisal in the staff report. While they were encouraged by the economic growth registered during 1992 and by the reduction in inflation to about half of that observed in 1991, Directors were most concerned about the fiscal slippage, largely as a result of which Honduras did not comply with many of the performance criteria of the economic program for end-December 1992.

Directors further observed that the deterioration of the fiscal position continued in the first half of 1993. They generally agreed with the authorities that Honduras needed to develop its economic infrastructure but cautioned that increases in investment, to be sustainable, needed to be supported by a stronger savings performance. The fiscal measures adopted in recent weeks were welcomed, as they provided an indication of the Government's renewed determination to bring economic performance to the path envisaged in the medium-term program supported by the ESAF. Nevertheless, the new measures were not particularly ambitious and, for 1993 as a whole, the overall fiscal deficit would again exceed the program objective. Directors emphasized the need to adhere strictly to the revised fiscal plan to avoid a further setback to the adjustment effort. In particular, they stressed the need to resist expenditure pressures even though 1993 was an election year. Looking ahead, Directors believed that it was essential that the program for 1994 under the second-year ESAF arrangement include a much more determined fiscal effort.

Directors noted that credit policy had been looser than programmed during 1992 and in the first half of 1993. Inflation had been on an upward trend in recent months, international reserves had declined, and the lempira had depreciated considerably. Therefore, they supported the recent monetary measures and emphasized the importance of maintaining a tight rein over credit in order to facilitate achievement of the authorities' inflation and international reserve targets while stabilizing the currency. Directors further observed that for the future, rediscount operations should be reduced while open market operations should gradually take over from reserve requirements as a key instrument for monetary control.

The difficult medium-term outlook for the balance of payments was a cause for concern for Directors, as it now appears that Honduras will need exceptional financing to a larger extent than anticipated initially in the medium-term program. The continuation of sizable external financing gaps after the ESAF period was of considerable concern. While the revised outlook reflected in part restrictions on banana imports by the EC and low coffee prices, Directors noted that a stronger adjustment over the medium term than envisaged earlier, particularly in the fiscal field, would be required to strengthen the external position. They also stressed the need to advance the process of structural change to foster domestic savings and private investment, and thus to improve Honduras' growth prospects. In this connection, Directors also noted the importance of developing nontraditional exports.

Directors noted with concern that external payments arrears on government debt to certain external creditors are still outstanding, and they emphasized the importance of the authorities keeping their commitment to eliminate them by the end of 1993. A sustained effort to implement appropriate policies along the lines envisaged in the medium-term program supported by the ESAF would be critical to elicit the required external assistance.

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

The Executive Board took the following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Honduras' exchange measures subject to approval under Article VIII, Sections 2(a) and 3, in the light of the 1993 Article IV consultation with Honduras conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Honduras maintains exchange restrictions subject to approval under Article VIII, Section 2(a), as evidenced by certain external payments arrears, and a multiple currency practice subject to approval under Article VIII, Sections 2(a) and 3, arising from the market rate and the rate at which the Central Bank purchases foreign exchange from commercial banks and exchange houses. In view of Honduras' intention to eliminate the multiple currency practice by end-September 1993 and the restrictions evidenced by arrears by end-March 1994, the Fund grants approval for their retention until end-September 1993 and end-March 1994, respectively.

Decision No. 10424-(93/102), adopted
July 23, 1993

Enhanced Structural Adjustment Facility -
Review Under First Annual Arrangement

1. Honduras has consulted with the Fund in accordance with paragraph 2(d) of the first annual arrangement under the enhanced structural adjustment facility (ESAF) for Honduras (EBS/92/110, Sup. 2) and paragraph 26 of the letter dated June 16, 1992 from the Minister of Finance and the President of the Central Bank of Honduras.

2. The Fund decides that the midterm review contemplated in paragraph 2(d) of the first annual arrangement under the ESAF for Honduras and paragraph 26 of the letter referred to above has been completed, and that notwithstanding paragraphs (2)(a)(i), (ii),

(iii), and (v) and 2(b) of the arrangement, Honduras may request disbursement of the second loan specified in paragraph 1(c)(ii) of the same arrangement.

Decision No. 10425-(93/102), adopted
July 23, 1993

3. INTERIM COMMITTEE - CHAIRMAN

The Chairman said that he had been informed by Mr. Solchaga that he had sent a letter to all members of the Interim Committee announcing his resignation as Chairman of the Interim Committee. Mr. Solchaga had ceased to be Minister of Economy and Finance of Spain, and had taken up political responsibilities as spokesman for his party in Parliament. As a result, a new Chairman would need to be selected to preside over the September 1993 meeting of the Committee.

4. REPUBLIC OF KAZAKHSTAN - USE OF FUND RESOURCES - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on Kazakhstan's request for an initial purchase under the systemic transformation facility (STF) in an amount equivalent to SDR 61.875 million (EBS/93/113, 7/12/93; and Sup. 1, 7/22/93).

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

> On July 20, 1993, representatives of the Consultative Group for Kazakhstan met in Washington under chairmanship of the World Bank. This was the third meeting of the Group. At the first meeting--in Paris, in December 1992--the Kazakh authorities introduced to the international community their program of economic and financial reforms and sought financing commitments to underpin the reform effort. In May 1993, representatives of the Group met in Almaty to discuss Kazakhstan's technical assistance requirements; the authorities also reviewed the imminent prospects for the strengthening of the reform effort with a program of policies and measures, to be supported by the Fund under the STF. Following agreement in early July 1993 between the staff and the Kazakh authorities on an STF-supported program, the Consultative Group met on July 20, 1993 to pledge specific financing amounts, based on the earlier discussions and taking into account an estimated financing need of about $525 million for the STF program period, July 1993 to June 1994.
>
> A number of multilateral and bilateral donors and creditors pledged support to be available during, and in some cases also

following, the program period, assuming satisfaction of specific conditions attached to such financing. This proposed financing included World Bank credits covering import rehabilitation, \$180 million, and urban transportation, \$30 million; interstate credits from the Russian Federation, rub 150 billion; European Bank for Reconstruction and Development investment financing, up to ECU 300 million; and trade and investment credits from Austria, Belgium, Canada, Germany, and the United States, amounting to about \$50 million. Other Consultative Group representatives noted that their authorities were also preparing financing packages, including Japan, which indicated that it was ready to consider cofinancing the World Bank import rehabilitation loan, provided that a Fund stand-by arrangement for Kazakhstan was approved. Representatives also confirmed details of programs of technical assistance.

On the basis of prudent assumptions regarding the prospects for an early mobilization of the pledged financing, disbursements likely to be available for purposes of closing the identified financing gap during the STF program period are currently estimated at about \$390-400 million. On this basis, further financing of \$125-135 million remains to be identified. The staff will continue to work closely with the World Bank and other creditors to help mobilize the full amount of external financing needed to underpin the policies being implemented by the Kazakh authorities with the support of the Fund under the STF.

The Chairman noted that, although considerable support had been indicated at the pledging session for Kazakhstan, the financing gap for the STF program period had not been covered. While the possibility had been envisaged of moving ahead with an STF drawing before the estimated financing gap under a program was fully financed, the outcome of the pledging session for Kazakhstan was not, in his judgment, in harmony with the spirit of the STF.

As noted in his remarks at the conclusion of the discussion on the STF on April 23, 1993, the purpose of that exceptional effort by the Fund was not to let others step aside, but to engage and catalyze them more effectively, the Chairman remarked. The efforts of creditors needed to be reinforced, as the Kazakh authorities' program was a strong one and an important application of the STF. It was a matter of concern that support had not yet been forthcoming from some major creditors. Fund and Bank resources alone were not sufficient to ensure the success of the STF. Therefore, he had instructed the staff to continue close contacts with potential creditors to explore the availability of resources needed for the success of the program. As Directors were aware, a second purchase under the STF could take place only if the Fund found that there had been satisfactory progress in mobilizing the external financing necessary to support the policies being implemented with the support of the STF. He hoped that Directors would convey to their authorities the importance of the issue for Kazakhstan, and of supporting efforts to help members undergoing the transition from central planning to market systems.

The staff representative from the European II Department said that the National Bank of Kazakhstan had raised its refinance rate to 140 percent, effective that day, which was a prior action foreseen in the program. The rate would be raised further to at least 170 percent within three weeks. The staff had also received updated information that indicated a monthly inflation rate of 17 percent in June, about the same level as in May, which was below the trend path assumed in the program. Provisional budget data for the first half of the year indicated a small overall deficit of less than 1 percent of GDP, which was substantially below the end-June target in the program of about 2 1/2 percent of GDP. Although complete information was not yet available, the budgetary outcome appeared to have been achieved mainly through expenditure restraint.

Mr. de Groote made the following statement:

> The measures implemented already, and those decided on for the next 12 months, would qualify Kazakhstan for an upper credit tranche stand-by arrangement if that country were in a position to manage its monetary and exchange rate policies independently. The authorities agree with the staff that more time is still needed to prepare the ground, domestically and elsewhere, for the adoption of a national currency. They also recognize that the full effect of the program submitted today for the Fund's support can only materialize when Kazakhstan becomes capable of controlling inflation through policies of its own in the framework of a regular stand-by arrangement. If the policies implemented in the ruble area do not rapidly lead to the stabilization of prices, the decision to remain in this currency area for the time being will be reviewed. The contingency measures needed to activate such a review have been carefully prepared, and can be triggered on short notice.
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> The information recently provided by the Russian authorities, and to the Board by the Russian chair, that Russia is urgently seeking clarification from other ruble area members on their positions with respect to an autonomous currency is regarded by my authorities as a significant indication for the options they presently are keeping under consideration. So is the suspension of the unlimited credit line from the Central Bank of Russia and the decision to allow, in the future, only limited interstate credits to the governments of the states of the former Soviet Union. In any event, October 1, 1993 is an important date, as it is the deadline for both the agreement on all balances outstanding between Russia and Kazakhstan and the commencement of operations of the Interstate Bank.

The program now being implemented is strong in both its macroeconomic and its structural aspects. The stance of fiscal and monetary policies corresponds to the requirements of a regular stand-by arrangement. The level of the minimum monthly wage, which is half that in Russia, and the substantial adjustment in real wages since the beginning of the year strengthen the chances that Kazakhstan will succeed in the fight against inflation once it has its own monetary management. The list of structural reforms in Table 6 of the staff paper is wide ranging; these measures clearly correspond to the specific requirements of the STF. Of particular significance are the scope and speed of privatization, the reform of the financial system, and the organization of a Treasury administration. The strength of the fiscal performance and of incomes policy--two areas where highly unpopular decisions have been implemented--is a clear sign of the authorities' resolve to implement unfailingly their commitments. President Nazarbayev has the political situation firmly in hand. Parliament and public opinion have rallied to the cause of transition to a market economy. The intensity of the democratic debate on all major options gives to the decisions a strong basis of common consent.

The assessment of the external financing needs for the second half of 1993 and for 1994 has, broadly speaking, given a result of the same order of magnitude that we had considered on the occasion of Kazakhstan's Article IV consultation in April 1993. It is a matter of great concern to me that although these needs have been carefully identified for more than six months, and the country today has access to an STF program of stand-by arrangement quality, reluctance has been observed on the part of official sources of financing to contribute to an effort that is now predominantly shouldered by the Fund. Let me recall that at my request the Board concluded its deliberations on the STF by stressing that access to this facility would signal the beginning of effective cooperation with the Fund. The measures forming the program are predicated on a financing need that, if it is not met, will oblige Kazakhstan to change the content of its program by introducing additional restrictive measures and accepting further income declines. By giving its agreement to the program that is proposed for Fund support today, the Board implicitly recognizes that the order of magnitude of the additional financing required is consistent with the measures of the program as they stand, and that these measures are appropriate for Kazakhstan's recovery during its transition.

Mr. Kagalovsky made the following statement:

I welcome the opportunity to discuss Kazakhstan's economic situation.

Some progress has been observed in Kazakhstan since the time of the April 1993 Article IV consultation, notably further elimination of budget subsidies, wage control, and further development of the tax base. A tight fiscal policy resulted in a small surplus in the fiscal outcome and paved the way for minimizing the financing of the budget through domestic banks.

New steps were undertaken on the monetary front. Following developments in Russia, the National Bank of Kazakhstan is gradually raising the refinance rate and has turned to resource allocation through the auction mechanism. The recent commitment to minimize domestic bank financing of the budget is especially commendable.

The policies envisaged in the STF program are largely consistent with the objective of a significant reduction of the disruptions inherent in the transition period. Still, several specific areas of macroeconomic adjustment give me cause for concern. The projected steps in the tax reform would certainly ease the fiscal tension; however, with the remaining narrow tax base and weak tax administration, the revenues might not reach the anticipated level of rub 3.3 billion by the end of 1993. If we look at the composition of the projected revenues, 68 percent of direct taxes is derived from corporate income tax. With the remaining unsustainable level of the internal and interstate enterprise arrears, the performance of the real sector might not permit the collection of taxes in the projected amounts. Remarkable breakthroughs are planned in the forthcoming weeks on the privatization front, and this is particularly commendable. However, turbulence, inevitable in the early post-privatization period, might result in less than anticipated corporate income.

I agree with the staff appraisal on another area of concern, namely, that Kazakhstan has probably reached the limit of further effective cuts in the budget expenditures. No capital spending is planned, except that from the extrabudgetary investment fund; the wage bill has been compressed so that wages are shrinking in real terms, and there are visible limits to this form of expenditure cuts. Actually, some flexibility is left only for further reduction of subsidies. At the same time, their reduction would put additional pressure on the wage adjustment.

Therefore, the stabilization gains achieved remain vulnerable and reversible. The policies for the first half of 1993 permitted the authorities mainly to restore control over government finances, which is a virtue in itself. However, these policies were not and could not be sufficient to achieve the principal objective of any stabilization program--reduction of inflation. All the rest of the regrettable drawbacks, such as perverse increases in trade regulations and difficulties in management of the monetary aggregates, derive largely from one main weakness--the absence of effective monetary instruments. Without them, all specific systemic policies remain ambivalent and inconsistent; they could be reversed any day, as they are based not on the indirect management of domestic finances, but on direct administrative measures, which are too vulnerable and too exposed to political uncertainties.

These considerations seriously devalue the successes referred to above and make the proposed program somewhat less viable than it looks on paper. Again, as it did three months ago, the staff refers to the uncertainty about future developments. Again, we observe that policies and developments in Kazakhstan are being largely determined by exogenous factors, rather than being shaped and managed by the national authorities. Though the program does not lack strong commitments and it covers all the key macroeconomic areas, the staff has had to admit that "one of the program's key objectives, notably, the targeted reduction in inflation, is partially outside the control of domestic policies."

The political bias for the introduction of an independent currency is understandable and deserves all due respect. However, we cannot but admit that, from a certain point of view, it is quite convenient for the time being to follow developments in Russia passively, undertake the painful adjustment in a piecemeal fashion, and refer to the lack of cooperation within the so-called ruble area. But such cooperation is not a one-way street. The pace and scope of the adjustment in Kazakhstan today clearly lag one or several steps behind the adjustment in Russia. The refinance rate of the National Bank of Kazakhstan was increased following the corresponding measures in Russia, and at any given moment it remains 10-15 percentage points lower than Russia's. The same is true with respect to increasing administered prices on basic commodities and services, as well as of the savings bank deposit rates. These indirect financial leakages from Russia continue to be complemented by direct ones: balance of payments financing until May this year was almost entirely provided through credit from Russia. The amount of such financing in 1992 and the first half of 1993 is equal to $1.25 billion.

Still, even under these circumstances there are ample opportunities for improvement of the macroeconomic position, in the event that the STF program is implemented as designed. Envisaged prudent income policies, further tightening of credit, further reform and streamlining of the tax system, and centralization of the financial resources in the budget would certainly improve the economic situation of the country.

Whether these prospects materialize or not depends almost entirely on the translation of commitments into action. I would very much appreciate elaboration by the staff on the issue of the rub 400 billion loan by the National Bank of Kazakhstan for replenishment of working capital of state enterprises at an interest rate of 25 percent at a time when the refinance rate was officially raised to 110 percent and then further to 140 percent. This is mentioned somewhat casually in the staff paper, but the issue deserves attention. The extent of such a loan is equal to at least $500 million. Just for comparison, this is approximately six times more than the amount of money the Fund intends to give Kazakhstan in the first tranche under the STF.

It is stressed more than once in the staff paper that the program qualifies for an upper credit tranche stand-by arrangement rather than for a drawing under the STF. It seems to me that management and staff are wise to proceed with a stand-by arrangement immediately after the STF drawing. It is certainly an excellent idea, but at present I would not share the staff's confidence that such a program can be developed and implemented smoothly enough. First, the financing gap is growing at an alarming pace, and there is no clarity on how it would be covered under the present circumstances. The last meeting of the Support Group for Kazakhstan shows that no creditor except Russia and some international financial institutions are willing to give any serious financial support to this country. Another problem with the financing gap is connected with Kazakhstan's share of the debt of the former Soviet Union. Kazakhstan has not signed an agreement with Russia on this issue; only an intergovernmental protocol has been signed. This document is not sufficient from a legal point of view. If there is no agreement, the financing gap will increase by far more than the figures we find in the balance of payments tables in the staff paper.

Second, and more important, by definition, financial stabilization programs can hardly be carried out without the introduction of an independent currency and the securing of meaningful instruments of macroeconomic management. Therefore, we should make it quite clear that there cannot be any sustainable stabilization given the lack of a national currency. This is the opinion of my authorities: no national currency, no stand-by arrangement. So we support an STF drawing for Kazakhstan now, without real assurance of a sustainable policy, as an exception. We suggest giving a waiver to Kazakhstan and allowing an STF drawing before the introduction of a national currency.

With these remarks, I endorse the proposed decision.

Mr. Oya made the following statement:

First of all, I would like to commend the authorities on reaching agreement with the Fund on an STF program and having already implemented many of the measures included in it, which has resulted in a consolidation of the fiscal situation and the containment of inflation.

In addition, I find the STF program satisfactory, because it contains necessary measures for successful economic reform, even with some quantitative objectives. I believe that the observance of the conditions of this program will lead to an early agreement on a full-fledged stand-by arrangement.

In order to enable the stand-by arrangement to be finalized, however, I would like to emphasize that it is crucial to attain monetary stability. I am concerned about how to attain this objective. In this respect, I agree with the staff that in the current situation the authorities should be encouraged to proceed quickly with monetary independence. In other words, I share the staff's view that it is most advisable and practical in the present situation for the authorities to introduce their own currency as soon as possible, as a delay in making this decision will result in monetary instability and jeopardize Kazakhstan's smooth transition to a stand-by arrangement. Approval of the STF program will give the authorities some breathing room in their reform efforts; however, I would be worried if it delayed the major decision I referred to earlier.

Regarding specific policy matters, I am concerned about three things in particular.

First, ruble note deliveries from the Central Bank of Russia have been suspended, and a severe cash shortage still remains. On the other hand, the authorities have not come up with a clear timetable for establishing a new monetary arrangement. These circumstances are vivid evidence of the uncertainty and instability of the monetary situation and could, therefore, adversely affect macroeconomic stability.

Second, I understand that negotiations are under way between Russia and Kazakhstan on the settlement of the correspondent account balances. The amount of the financing gap and the terms of repayment will depend upon the results of these negotiations, which could involve a complicated process and could result in a substantial increase in the financing gap. In this case, it is likely that the negotiations would delay agreement on a stand-by arrangement, or its contents would need to be changed.

In this connection, I would like to ask the staff about the prospects for these negotiations and the staff's ideas on a contingency measure related to any change in the STF program as a result of these negotiations.

Third, I am not certain whether the authorities have sufficient knowledge and experience to implement independent monetary policies and to issue their own currency. In this connection, I believe the Fund has much experience in this field, and I hope that the Fund will play a major role in providing technical assistance. My authorities are also ready to provide technical assistance to Kazakhstan to build up its financial system, including the issuance of a new currency.

As I mentioned, although I am satisfied with the ambitious STF program, fundamental uncertainty in the program about the monetary arrangement still remains. I hope that the authorities will be able to remove this uncertainty and proceed to a full-fledged stand-by arrangement as soon as possible. With this more solid program, external financial assistance will play a more valid role in promoting the reform process. In this respect, my authorities will be ready to consider possible measures to assist Kazakhstan, including parallel lending, provided that a stand-by arrangement is approved.

I am concerned that the authorities will encounter political and social pressures in the period ahead while they continue implementation of this program. Nevertheless, I hope that despite these pressures the authorities will keep in mind the fact that a smooth transition to a stand-by arrangement is the only way to successful economic reform, that they will implement all the measures in the STF program, and, even more important, that they will take the necessary steps toward a new monetary system.

With these remarks, I support the proposed decision.

Mr. Posthumus made the following statement:

I welcome the request by the Kazakhstan authorities to draw under the STF, and I support the proposed decision. It is already some time since I had hoped that the Fund could support a monetary union in the area of the former Soviet Union. This is clearly not realistic anymore, given the developments in the ruble area since then. The Fund's approach now seems to me to be the right approach. Kazakhstan should make the choice whether or not to leave the ruble area, and the Fund should support Kazakhstan as much as possible, even if it decides to stay in the ruble area. Nevertheless, I am a bit disappointed that we cannot discuss a request for an STF drawing combined with a stand-by arrangement today. I would be interested to hear from Mr. Kagalovsky why he thinks that Kazakhstan cannot have a stand-by arrangement while it remains in the ruble area even if Russia has a stand-by arrangement, which is the conclusion I draw from his earlier comments.

The pace of monetary stabilization in Kazakhstan is now dictated by developments in Russia. Russia is moving in the right direction, but the fact remains that Kazakhstan cannot overtake Russia in stabilizing its own economy. This is regrettable, because Kazakhstan has already made significant progress toward an upper credit tranche program, in the financial as well as in the structural area, as Mr. de Groote indicates in his exemplary statement.

Even when Russia continues to follow the right track--and there are no indications that it would not--there remain reasons for Kazakhstan to leave the ruble area. One such reason is that "ruble area monetary arrangements are not operating in the way a normal currency union should function," as the staff notes in its appraisal. Examples of this malfunctioning of monetary arrangements can be found on page 3 of the staff paper, where references are made to interruptions in the deliveries of ruble notes from the Central Bank of Russia, and to a sudden suspension of the extension of credit by the Central Bank of Russia to the National Bank of Kazakhstan. Mr. Kagalovsky mentioned a few examples of Russia taking monetary measures not followed immediately by Kazakhstan. I would be interested in any comment of the staff on this issue. Obtaining monetary autonomy by introducing its own currency, as favored by many Directors on the occasion of the previous Article IV consultation, would put an end to these disturbing uncertainties, which could even endanger implementation of the STF program. If Kazakhstan wants to remain in the ruble area, however, clear and transparent rules regarding monetary arrangements with Russia should be defined.

I support the staff's recommendations regarding the stance of monetary policy, which, pending the introduction of a national currency in Kazakhstan, will contribute to financial stability within the ruble area. In this respect, expansion of the credit auction system will be of great importance, as it will limit the possibility of government interference with the allocation of credit.

Although I recognize that the target for the budget deficit cannot be judged according to stand-by arrangement standards, I wonder why a more ambitious fiscal program has not been chosen. A more ambitious approach would definitely improve circumstances under which a national currency could be launched. Of course, the 6 percent of GDP deficit target for 1993 is the same as under the Russian program, and the deficit for 1993 would have been much higher without policy actions foreseen in the program.

> Nevertheless, it should be noted that according to the program, the deficit will increase in 1993 and capital expenditures, starting from a very low level, will hardly increase, while current expenditures are programmed to rise by nearly 1 percentage point. Capital expenditures could be constrained even further if parliament does not approve envisaged tax measures in October.
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> Unfortunately, a financing gap under the program of about $130 million remains at this stage. Kazakhstan can perhaps reduce the financing requirement somewhat by speeding up the process of dismantling the system of export quotas and export licenses. Furthermore, there seems to be room to improve the processing and administration of foreign direct investment inflows. Lower levels of foreign investment and exports certainly have a counterpart in smaller imports, as the staff points out, but I assume that this is not an argument against such efforts.

Mr. Kagalovsky remarked that Mr. Posthumus had raised a very important issue, namely, how the Fund should deal with a scenario in which Russia had a stand-by arrangement with the Fund and Kazakhstan, or any other country, wanted to remain in the ruble area and have a stand-by arrangement. In his view, in order to maintain an appropriately tight monetary policy, there was one simple principle: one currency area, one central bank. There could be only one body for making decisions about monetary policy in a currency area, and it was widely recognized that for the so-called ruble area that body was the Central Bank of Russia. In such a scenario, Kazakhstan would have to be prepared to sacrifice part of its national authority, and the National Bank of Kazakhstan would have to be a branch of the Central Bank of Russia. As a result, the Kazakh authorities would have no independent control over monetary policy in Kazakhstan. Moreover, if a stand-by arrangement for Russia failed, a parallel arrangement for Kazakhstan would automatically fail. From the point of view of the Fund, it was not clear that the institution could approve an arrangement for a partner that did not have sufficient authority to fulfill its conditions. Therefore, his chair would not support such an arrangement.

Mr. Laux stated that he disagreed with Mr. Kagalovsky. In his view, it would indeed be possible for Kazakhstan to have a stand-by arrangement while remaining in the ruble area as soon as Russia had a stand-by arrangement. The important point was that the monetary policies of both countries would have to be consistent, aimed at the same targets, and linked to each other in a positive sense. It was true, of course, that if a stand-by arrangement for Russia went off track, a parallel arrangement for Kazakhstan would automatically go off track as well, which was a strong argument in favor of Kazakhstan introducing a national currency. It would be possible, however, to approve a stand-by arrangement for Kazakhstan without its having first introduced its own currency.

Mr. Posthumus remarked that he agreed with Mr. Laux. The decision to approve a stand-by arrangement for Kazakhstan would depend entirely on the way the currency union functioned and the agreements made between the central banks of the currency union. Those arrangements, of course, would have to be approved by the Fund before they could be incorporated into a stand-by arrangement with either of the two partners.

The Chairman said that, taking the broader context into account, it would be highly desirable for Kazakhstan to introduce its own currency with as much technical and financial support as possible from friendly countries and multilateral institutions.

Mr. Al-Jasser commented that we wished to associate himself with the comments of Mr. Laux. Given the strong views of the Russian authorities on the issue, and the fact that several smaller countries of the former Soviet Union had already adopted their own currencies, he wondered why there had been a delay in introducing a national currency in Kazakhstan.

The staff representative from the European II Department noted that, as set out in the staff report for the 1993 Article IV consultation with Kazakhstan, there were three aspects to the introduction of a national currency. As far as the technical aspects were concerned, preparations had been completed. If they felt it appropriate, the Kazakh authorities could introduce a national currency very quickly. He could reassure the Board that the preparations had been made in close collaboration with the staff, including in the form of technical assistance, over the previous six to nine months. With respect to the second aspect, the Kazakh authorities had felt that it was vitally important that all supporting policies be in place--adequate budgetary policies, the institutional capability of the National Bank to run a tight monetary policy, and foreign exchange policies to support the new exchange rate regime and the national currency. They had been working on those issues for three to six months, and in their judgment, which was shared by the staff, the necessary supporting policies were nearly in place.

The third aspect, which was perhaps the most complicated, was the issue of relations between Kazakhstan and Russia, the staff representative said. Indeed, the staff and the Kazakh authorities had experienced great difficulty over the previous six months in interpreting a series of mixed and uncertain signals about the preferences of the major shareholders of the ruble area, including the Russian authorities. The Kazakh authorities had been assured by the Russian Government at the highest level that Russia wanted Kazakhstan to stay within the ruble area. It was in that context that the National Bank of Kazakhstan, alone among all members of the ruble area, had an unlimited line of credit with the Central Bank of Russia and had been assured that they would receive the new 1993 ruble notes from Russia. In fact, the National Bank's line of credit had been suspended in May 1993 and there had been no deliveries of new ruble notes, although deliveries of old ruble notes had resumed. Russia had also proposed that Kazakhstan should stay within a mini-ruble area, consisting of four or five ruble area states.

Those discussions between the Russian authorities and the Kazakh authorities had been under way for three to six months, and at no time had it been totally clear what either side really wanted to do in the immediate future, the staff representative from the European II Department commented. The bottom line was that the Kazakh authorities had decided that they wanted monetary independence, and the only question that remained was one of timing. It was the staff's belief that the authorities were likely to move to monetary independence very soon. The authorities would like to make such a move in the context of a stand-by arrangement with the Fund and with adequate financial support from creditors and donors to back the introduction of a national currency.

The Chairman observed that the present meeting had provided the Board with a useful clarification of the intentions of both the Kazakh and the Russian authorities, the basic strategies of which were essentially consistent. The remaining question was one of timing. Directors certainly agreed on both the desirability and the possibility of a stand-by arrangement for Kazakhstan very soon, and, in his view, the process was moving speedily toward the desired separation of currencies with the support of not only the international community but also the Russian authorities.

Mr. Kagalovsky said that he could agree with the Chairman's assessment of the situation. He was certainly pleased that there was a consensus that the best approach for Kazakhstan was to introduce its own currency as soon as possible. As a matter of principle, of course, Russia had no objection to Kazakhstan, or any other country, using the Russian ruble or any other currency, as many countries with weak currencies were using the U.S. dollar.

Mr. Dawson stated that he wished to associate himself with the views of Mr. Al-Jasser, Mr. Laux, and other speakers on the relationship between a stand-by arrangement for Kazakhstan and its progress in attaining monetary independence.

Mr. de Groote remarked that he welcomed the clarity of Mr. Kagalovsky's statement, which was extremely useful. He also agreed completely with the comments of the staff representative. Indeed, as he had noted in his introductory statement, the authorities could trigger a move to monetary independence very rapidly. The supporting policies were in place and could easily be incorporated in a stand-by arrangement, which was clearly the wish of all Directors. On Kazakhstan's relations with Russia, it was his understanding that the Kazakh authorities wanted to consider the timing of the decision on the introduction of a new currency in the context of the arrangements that would be agreed with Russia on the outstanding mutual claims and debts and on the functioning of the Interstate Bank. They did not envisage the introduction of an autonomous currency without having first very clearly settled all their relations with Russia on a sound legal basis, a view that corresponded entirely with the wish expressed by Mr. Kagalovsky.

Mr. Dorrington said that he very much agreed with the sentiments expressed by Mr. Laux and other speakers.

Mr. de Groote noted that it was clear that, whether or not Kazakhstan adopted an autonomous currency, relations between Kazakhstan and Russia would remain very close. At the political level, the Kazakh authorities, mindful of the harmony of their views with those of the Russian authorities on a range of issues, wanted to know first whether the ruble area would be able to continue to function, whether inflation in Russia would be controlled in due course, and whether it would be possible to follow the measures taken in Russia, as they had done, without incurring major risks on the inflation front. In that context, it was quite understandable that the Kazakh authorities wanted to take time to reflect before taking a decision on monetary independence.

Mr. Fridriksson made the following statement:

I welcome the progress that Kazakhstan continues to make toward an upper credit tranche arrangement with the Fund. Only three months have passed since the Board considered the staff report for the 1993 Article IV consultation with Kazakhstan, and since then, the authorities have moved to further underpin their reform effort. I should also note here that I have just learned that on July 21, 1993, Kazakhstan signed a free trade agreement with Lithuania.

I agree with the staff that it is mainly in the monetary area that further progress is needed for Kazakhstan to qualify for a stand-by arrangement with the Fund, and that the policies that the authorities have adopted meet the requirements for a drawing under the STF.

I fully endorse the staff appraisal and recommendations, and shall limit my remarks to commenting on a few specific issues.

In view of the statements that have already been made today by Mr. Kagalovsky and the staff representative on monetary relations with Russia, and on the preparatory work that has been undertaken for the possible adoption of a national currency later this year, I urge the Kazakh authorities to make a timely break with the ruble area. The authorities have clearly demonstrated their ambition to promptly stabilize the economy, and an early introduction of a national currency may become unavoidable if these ambitions are not to be frustrated. The introduction of a national currency could well take place in the context of a stand-by arrangement with the Fund. In this connection, I also noted Mr. de Groote's comments on the preconditions that the authorities think will have to be met before they introduce their own currency. Having said this, I also wish to state my agreement with the comments of Mr. Laux.

An independent currency will give the authorities full control over economic policies, and with it the responsibility to pursue appropriate financial policies. The experience of the Baltic countries shows that it is possible to achieve rapid progress in macroeconomic stabilization, given appropriate financial policies.

I welcome the adoption by parliament in April 1993 of the statutes of the National Bank of Kazakhstan, as well as the law on banking and foreign exchange. These are important steps toward an improved functioning of the banking system. I also wish to emphasize the importance of moving the refinance rate of the National Bank to market levels, and in that respect I welcome the information that the rate was increased today, with another substantial increase expected within three weeks.

I noted the reported severe shortage of cash rubles in the spring, as well as the staff statement today that rubles are now being supplied. I would, however, welcome a comment from the staff representative on what might be the implications of Russia's decision to supply only old ruble notes to Kazakhstan and not new ones. In any case, the so-called ruble area does not appear to be functioning like a currency union.

On the budget, I note the uncertainties expressed by the staff concerning legislative approval of tax measures and the ability of the authorities to compensate for possible inaction by reducing expenditures. The fiscal area is a crucial part of the program, and I urge the authorities to implement it fully. Perhaps there is even a reason to strengthen the fiscal effort beyond what is currently envisaged, and here I sympathize with the comments of Mr. Posthumus. I note, for example, that subsidies are still expected to amount to about 5 percent of total government expenditure in 1993, similar to the 1992 level. I welcome, therefore, the plans referred to in the staff paper to review subsidies before the end of the year with a view to reducing and replacing them with targeted transfers.

The results of the pledging session of the Consultative Group that was held earlier this week were apparently rather disappointing, and I share the concerns of Mr. de Groote and the Chairman in this respect. I wonder whether the staff or others can shed light on the reasons for the unresponsiveness of expected important contributors and on why a STF program has not catalyzed greater assistance than seems to be the case. It is unreasonable to expect the Fund--and the Bank--to bear the brunt of the external financing, and one would have expected greater participation on the financing side in connection with the STF drawing. If the expected financing is not going to materialize, even in connection with a stand-by arrangement, then policies in Kazakhstan will have to be correspondingly tightened, and production and income will develop more unfavorably than otherwise.

Conspicuous by its absence from the group of potential donors and creditors listed in the statement by the staff representative is the European Community, which, according to the staff paper, was expected to be an important contributor. I welcome the decision of the Chairman to have the staff work closely with creditors and donors to help mobilize the full amount of external financing needed to underpin the policies being implemented.

While on the issue of external financing, I noted the terms proposed by Russia for the conversion of correspondent account balances into interstate credit, contained in footnote 2 on page 3 of the staff paper. These seem to be rather stiff terms, and in that respect, I wonder whether the staff can tell us what the terms for the Russian commitment within the Consultative Group are likely to be. Does that commitment also entail a security deposit, for example, and what is the true purpose of such a deposit? As far as the outstanding correspondent account balances is concerned, I would also like to ask for the staff's views on the proposal to convert them into U.S. dollars at the exchange rate as of the end of 1992. How are these balances accounted for in the balance of payments projections?

I note and welcome the intention of the World Bank to get involved in a variety of areas, including privatization and financial sector reform. In my view, the Bank can play an absolutely crucial role, and I would encourage an early active role in order to ensure that essential structural reforms do not significantly lag behind macroeconomic stabilization, which has been the experience in the Baltic countries.

While on this point, I would like to ask the staff to elaborate further on privatization, in particular of agricultural land.

In conclusion, Kazakhstan is richly endowed with natural resources and has the potential to develop rapidly. Given appropriate macroeconomic and structural reform policies, Kazakhstan should be able to attract considerable foreign direct investment. The authorities have embarked upon a program that merits support under the STF. In the months ahead, the authorities will have to take crucial decisions relating to their monetary arrangements, which, judging by today's discussion, will entail the introduction of a national currency. Highest priority in their deliberations should be given to the urgency of sharply reducing inflation and rapidly moving toward macroeconomic stabilization, and of creating the appropriate institutional setting for that task. I hope that a request for a stand-by arrangement will be brought to the Board within a short period.

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

5. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Esdar upon completion of his service as Alternate Executive Director for Germany.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/101 (7/16/93) and EBM/93/102 (7/23/93).

6. FEDERATED STATES OF MICRONESIA - DESIGNATION OF DEPOSITORY

The Fund accepts the Bank of Hawaii, Pohnpei Branch, as the depository, under Article XIII, Section 2(a), for all the Fund's holdings of the currency of the Federated States of Micronesia (EBD/93/124, 7/14/93).

Decision No. 10426-(93/102) adopted
July 19, 1993

7. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 92/139 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/93/131 (7/15/93), EBAM/93/133 (7/16/93), EBAM/93/134 (7/20/93), and EBAM/93/135 (7/21/93) and by an Assistant to Executive Director as set forth in EBAM/93/132 (7/15/93) is approved.

9. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/93/47 (7/16/93) is approved.

APPROVED: November 30, 1993

JOSEPH W. LANG
Acting Secretary