NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/148

10:00 a.m., October 27, 1993

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	M. Sirat
	D. Desruelle, Temporary
J. Bergo	
	J. Prader
	J. Jonas, Temporary
H. Fukui	T. Oya, Temporary
K. P. Geethakrishnan	
J. E. Ismael	K.-T. Hetrakul
	K. Link
	R. F. Cippa, Temporary
A. Kafka	J. C. Jaramillo
	A. V. Mozhin
	B. M. Lvin, Temporary
G. Lanciotti	S. Vori, Temporary
R. Marino	
	O. Kabbaj
	B. S. Dlamini
	J. Dorrington
G. A. Posthumus	
	Y.-M. T. Koissy
S. Schoenberg	
A. S. Shaalan	Y. Y. Mohammed
	K. J. Langdon, Temporary
	Y.-H. Lee, Temporary
	Wei B.
A. G. Zoccali	
	J. M. Abbott, Temporary

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

Also Present
IBRD: J. M. Biderman, Europe and Central Asia Regional Office. European I Department: G. Bélanger. European II Department: J. Odling-Smee, Director; A. Kammer, A. Knobl, A. Lellep, T. Shikado, T. A. Wolf, B. B. Zavoico. External Relations Department: P.-M. Falcone. Fiscal Affairs Department: J. Escolano. Legal Department: R. H. Munzberg, Deputy General Counsel; H. Elizalde, R. B. Leckow. Middle Eastern Department: M. A. El-Erian. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; D. Burton, S. A. Coorey, M. D. S. Heysen-Zegarra, K. M. Meesook, D. O. Robinson, S. M. Wakefield. Secretary's Department: J. M. Boughton, A. Jbili. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; E. Decarli; L. U. Ecevit, S. J. Fennell, H. Flinch, D. Gupta, K. M. Kenney, M. A. Wattleworth. Western Hemisphere Department: B. C. Stuart. Advisors to Executive Directors: G. M. Blome, A. Chang Fong, S. K. Fayyad, J. M. Jones, M. F. Melhem, J.-C. Obame, A. Raza. Assistants to Executive Directors: H. M. Al-Atrash, S. Al-Huseini, D. A. Barr, J. H. Brits, J. M. Burdiel, A. Cathcart, G. El-Masry, J. C. Estrella, S. S. Farid, R. Ferrillo, A. Galicia, H. Golriz, M. A. Hammoudi, C. Imashev, S. Ishida, W. C. Keller, N. Laframboise, G. J. Matthews, S. C. McDougall, S. del C. Olgiati, C. F. Pillath, N. Prasad, M. Ryan, D. Saha, A. Sighvatsson, F. A. Sorokos, A. Viirg, Wang X., Wang Y., Wu H.

1. ACCESS POLICY - GUIDELINES ON ACCESS LIMITS - REVIEW

The Executive Directors considered a staff paper on the review of access policy and limits under the credit tranches and the extended Fund facility (EFF) (EBS/93/160, 9/23/93). They also had before them a paper reviewing the Fund's liquidity position and financing needs through the end of 1994 (EBS/93/155, 9/15/93).

Mr. Dorrington made the following statement:

At the Board meeting on this subject 12 months ago, deeply felt arguments were put forth on both sides, and a difficult compromise was finally reached. I do not believe that any useful purpose would be served by repeating all those arguments today, but rather we should be asking ourselves whether circumstances have changed sufficiently during the subsequent 12 months to justify a change in access limits. I also believe that there should be a strong presumption for no change, since it is surely undesirable for access limits to move up and down from year to year according to changes in circumstances that might prove short-lived.

One important change that has occurred is that concerns over liquidity have been allayed considerably, and thus the case for lower limits is less powerful than it was last year. Of course, we must always be prepared to consider a reduction in access if liquidity or other considerations cause serious concern, but fortunately, we are not faced with that today.

This is not of itself an argument for an increase. To argue for an increase it would also be necessary to show that access limits were inhibiting, or likely soon to inhibit, the Fund from playing its proper role. The staff paper clearly demonstrates that this is not the case. Indeed, the probability of access limits acting as a constraint now appears less than it did a year ago. One reason for this is another major change during the last year, the creation of the systemic transformation facility (STF). This effectively increases access for many of the countries that might have been constrained without it. Thus, in this respect, the case for higher limits has also been weakened over the last year.

One thing that has not changed is the share of gross Fund financing as a proportion of members' projected gross financing needs, which, at 8 percent, remains around the average of recent years. On this measure, the Fund is continuing to play its full catalytic role.

In considering the case for a change in limits, it is also important to remember the flexibility in the current system. In particular, if access limits were to act as an unreasonable constraint on use of Fund resources by an individual member, then we have the possibility of bringing the exceptional circumstances clause into play. This chair would be prepared to consider individual cases on their merits; it is possible that we may need to be more flexible than has typically been the case in the past. Certainly, there is no need to make a general change in access limits in order to accommodate the possibility of isolated special cases.

Nevertheless, if at some time in the future it becomes clear that access limits were preventing the Fund from performing its full role in respect of a significant number of its members--or were about to do so--and if other factors including liquidity considerations permitted, this chair would then be ready to consider higher access limits.

While there have been changes in the circumstances ruling at the time of the setting of access limits a year ago, these changes do not all point in the same direction. The changes should have calmed the fears of both those who argued for higher and for lower access limits, rather than reinforced their arguments for different figures. The compromise last year was a difficult one, and I see no reason to disturb it. Thus, I support the proposed decision.

Mr. Schoenberg made the following statement:

I support the proposed decision to retain current access limits for another year. Nevertheless, I should like to add some brief remarks, starting with the staff projection of the potential demand for Fund resources until the year 1995. The revised estimate is considerably lower than that of last fall. While acknowledging the substantial difficulties associated with such estimates, such major revisions underline the need to prepare the projections with as much care as possible in order to avoid sizable overestimations, which could impair the credibility of future forecasts and raise expectations in member countries that might be difficult actually to fulfill.

The staff's current projections seem to contain some weaknesses, in particular with regard to the projection of members' financing needs--excluding the republics of the former Soviet Union--for 1993-1996. These estimates are now about 3 percent higher than in the comparable forecast in the fall of 1992. The staff explains that the increase in the projection is attributable to higher current account deficits of some middle-income countries experiencing surges in capital inflows. This argument is problematic, in my view, as a surge in capital inflows should allow a relatively smooth financing of any corresponding current account deficits that are larger as a result of such inflows. In any case, it is difficult to see how the need for financing by the Fund would increase as a result of capital inflows. Instead, larger capital inflows could be used--and are indeed being used, at least partly--by member countries to build up reserves or to buy back foreign debt, rather than to finance more imports. Therefore, such transactions might very well lead to a reduction in financing needs, at least in net terms. Research into that matter reveals that, in earlier years, the financing needs of some middle-income countries were assessed partly in relation to expected capital outflows. When comparing that line of reasoning with the present argument in the staff paper, the impression is left that all private capital flows, regardless of their direction, will inevitably lead to an increase in a member's financing needs. I therefore doubt that the concept of gross financing needs makes much sense in the context of evaluating future demand for Fund resources, as variations in international capital flows do not necessarily have an impact on net financing needs.

I am also not totally convinced by the staff's argument that private financing may become less readily available to developing countries following a potential recovery in industrial countries, which might be accompanied by an increase in international interest rates. This expectation is based on the assumption that industrial countries and developing countries compete for scarce capital in the same segment of the capital market, which cannot be considered as certain. Moreover, it is to be expected that developing countries will profit from a recovery in industrial countries through larger exports, which could lead to a corresponding reduction of external current account deficits and financing needs as well.

We are confronted with a similar two-way argument in the proposition that a recovery in industrial countries is both good and bad for the external financing prospects of developing countries. I am not criticizing the staff's analysis--the staff itself refers in footnotes 2 and 3 on page 3 to some of the operational difficulties--but we should be aware of the limited operational relevance of any calculations involving gross financial flows.

Despite these reservations, I share the staff's basic conclusion that future financing needs of member countries will be relatively large in comparison with previous periods. I also agree with the staff's view that the Fund should continue to play a decisive role regarding the financing of adjustment programs aimed at tackling balance of payments imbalances, although I should like to emphasize that, given the Fund's limited resources, we see that role as mainly a catalytic one.

The experience so far has demonstrated that the new access limits are not too low. Average access--at 31 percent of quota--has remained considerably below the general access limit of 68 percent of quota, which is to be welcomed. However, the fact should be overlooked that the new access limits are still high when compared with historical standards, and that raises a question about whether or not the current access limits and levels can be maintained permanently and financed through Fund resources.

The Fund's liquidity position, although comfortable at the moment, could deteriorate rapidly in the coming years, in view of the many risks and imponderables. It is also not certain that the next quota increase will come into force in time. The Fund could therefore face the prospect, at some future stage, of having either to adjust the access limits or take up new credits from member countries. These imponderables underscore the need for regular reviews of the Fund's access policy.

Although I do not want to revive the lengthy discussion we had recently on the question of an SDR allocation, I should like to point out that the Fund's currently comfortable liquidity position appears to strengthen the argument that there is no shortage of conditional liquidity in the global economy. From that perspective, there is no need to allocate new SDRs in favor of countries with protracted balance of payments problems.

Mr. Dlamini made the following statement:

The staff's recommendation is that the current access limits should be maintained for the coming year. I can support the proposal if there is a consensus, although we have maintained the position that higher limits were warranted given the state of the world economy and the financing needs of a large segment of the Fund's membership. I am also aware that the Fund must strike a reasonable balance between its lending operations and the need to maintain a strong liquidity position.

My concern is with the application of the policy on access limits. The level of actual access leaves one to wonder whether the Fund has made use of the scope provided by the policy, as suggested in the staff paper, to give appropriate support to the adjustment effort of member countries.

At a time when the world economy is in such serious difficulty, and external imbalances remain large for a good number of countries that do not have access to capital markets, it would appear anomalous that Fund financing has averaged only about 8 percent of the members' projected gross financing need. It is little consolation that this figure is broadly in line with the average for recent years, since the external environment seems to have worsened in the past year. In fact, there was a slight decline in actual access in absolute terms. One would have to hear more from the staff as to the reasons for actual access being 31 percent of quota--less than half of potential access. The suggestion on page 7 of the staff paper that, in general, the Fund's relative role in providing financing has declined because of the success of reform efforts and the associated headway in gaining access to other sources of financing is not fully convincing, especially considering the countries listed in Table 1.

In fact, I would put more emphasis on the observation in the paper that the availability of financing for many developing countries and most of those economies in transition appears to be quite limited. This draws attention to the fact that the catalytic role of the Fund is becoming more difficult, suggesting that the Fund must be prepared to rely more on its own financing to ensure that it continues to meet its central role in supporting economic adjustment efforts.

In sum, I would urge that actual average access should not be unduly constrained, because there is a critical external financing need in many countries that is not presently being met, thus limiting investment and growth in these countries. A more flexible approach in administering the policy would not undermine the liquidity position of the Fund.

Mr. Sirat made the following statement:

The staff paper correctly captures the main requirements which must guide any consideration of access policy. These are, first, that access limits must effectively allow the Fund to meet its central, albeit catalytic, role in supporting member countries in their efforts to adjust and reform; second, that access limits constitute an important signal that the Fund sends to the outside world about its willingness to play this central role and, thus, to meet its responsibilities; and finally, that one of the key features of the new policy the Board adopted in 1992 was to *maintain potential access for all members in SDR terms*.

I fully support the thrust of the staff's appraisal on how the new limits have worked since then. Consequently, I fully endorse the proposal to maintain access limits at their current levels for the time being. Indeed, I see three main arguments in favor of such a position.

First, current access limits have worked as intended, that is, they have worked as ceilings, not as targets. Effective access has been much lower, at 31 percent on average. In fact, the staff's calculations point to a slight decrease--of

3 percentage points--in absolute average access since the increase in quotas and the implementation of the new policy. This being said, one can broadly share the staff's view that, thanks to the necessarily prudent management of effective access, access determination within the limits has essentially represented a continuation of recent experience.

Second, 11 months is certainly too short a period in which to reach a definitive judgment. In addition, the number of stand-by and EFF arrangements concluded during this period--12--is relatively small compared with previous years. It can thus be argued that the new limits have yet to be fully tested, and as Mr. Dorrington said, there should be a strong presumption for no change. In this regard, the staff presents a short-term outlook for developing countries and countries in transition in which downside risks are not insignificant; taking into account the sluggish growth in industrial countries, the poor terms of trade prospects, and the persisting uncertainties in many regions, especially Africa, the Middle East, Eastern Europe, and the countries of the former Soviet Union. The staff also correctly mentions the questions raised, in terms of sustainability and durability, even for developments as favorable as the increase in capital inflows to some developing countries. It is noteworthy that an agreement reached since the staff paper was issued--the stand-by arrangement for Viet Nam--came at 60 percent of quota, much closer to the potential limit than other agreements reached since last November. For all these reasons, I would stress that caution pleads in favor of sufficiently high access limits.

Third, there is the Fund's liquidity position. On the one hand, liquidity should not be considered as a determining factor in setting the access limits. Indeed, low liquidity levels can point to insufficient Fund resources, not necessarily to excessive access. On the other hand, the liquidity situation is a part of the context for taking decisions about access. The large upward revision in the projected liquidity ratio is certainly a very reassuring development in this regard, even though its causes are not so favorable--that is, owing to the difficulties experienced by many countries in formulating economic programs. In any case, the very volatility of the projections of the liquidity position--from 35 percent to 50 percent at end-1995 estimated in November 1992, to 110 percent estimated now--clearly illustrates the caution with which such projections should be used in setting up access limits, which should be stable enough to be sufficiently predictable for members.

I concur that the current access limits for the credit tranches and extended arrangements can and should be maintained. This does not relieve us of the duty to ensure that the poorest countries in the membership continue to have access to arrangements of the enhanced structural adjustment facility (ESAF) type as well. I hope we will make further progress in the very next few weeks toward this objective.

Mr. Fukui made the following statement:

The important new element in this year's review is the large change in the liquidity ratio projection. The staff now says that the liquidity ratio is expected to be of the order of 110 percent by end-1995, whereas at last year's Board discussion, it was projected to be between 35 percent and 50 percent. A simple implication of this large change in the liquidity ratio is that there is room for increasing the access limit from 68 percent. However, since actual access has been sufficiently within the limit, there is no practical need to raise the limit.

However, this large increase in the liquidity ratio makes it equally difficult to argue for reducing the limits. We must also remember the principle discussed last time, which is that no one should lose by the coming into effect of the Ninth General Review. We believe that this principle still stands. All in all, we do not believe that there are any substantial reasons to change the present limit in either direction, given the present projection for the liquidity ratio.

The large change in the liquidity ratio projection reminds us, however, that it is based on various assumptions and is quite vulnerable to changes in circumstances, in particularly vis-à-vis the countries of the former Soviet Union. Certainly, most of the large change in the liquidity ratio projection can be explained by the simple fact that the pace of reaching agreements with those countries has been slow. According to our calculation, another SDR 1 billion of new commitments would easily change the ratio by about 6 percent.

In view of the above, and also because such basic parameters as access limits--which represent the Fund's policy stance--should not be changed easily, it is unnecessary either to raise or lower the limits this year. However, taking into account the vulnerability of the liquidity ratio and the dynamic changes in the world economy, it would be appropriate to review the liquidity ratio on a continual basis. I would ask the staff to report to us on the liquidity ratio, as appropriate, for our further reference.

I agree with the proposal.

Mr. Posthumus made the following statement:

I agree that, during the first year of the new access policy, the access limits have provided adequate scope for the Fund to give appropriate support for the adjustment efforts of Fund members. I welcome the staff estimates of a strongly improved liquidity ratio for the coming years. It should be noted, however, that this improvement is not due to better external prospects for the membership as a whole, nor to a basic change in the role of the Fund. On the contrary, the estimated gross financing needs have increased somewhat, and the Fund has--at least in theory--enlarged its role in the countries in transition by the introduction of the systemic transformation facility (STF).

The large change in the staff's estimates of the liquidity ratio shows how tentative and volatile such projections are, which stresses the importance of reviews of the access limits on a regular basis. It is possible that, in the future, liquidity ratio estimates may drop as suddenly as they have risen in the staff's most recent analysis. In such a situation, timely reconsideration of the access limits would be called for. To allow for financing of Fund-supported arrangements at all times, and to limit the risk of a deterioration of the Fund's liquidity ratio in the long run, our position has been to impose a cumulative access limit at the level of the long-term self-financing ratio, which the staff calculated in the past at 250 percent.

A reduction in the cumulative access limit seems possible without putting binding restrictions on the use of Fund resources, in line with the needs of members as can be expected at this time. From the information in the staff paper, I get the impression that neither the annual limit nor the cumulative limit acts as a constraint on appropriate support for members' adjustment efforts, but the cumulative limit seems even more unconstraining than the annual one. Looking at Table 1 of the staff paper, we see that average annual access under programs approved since November 1992 was 31 percent of quota, compared with a limit of 68 percent. If we make the same calculation for the amount of credit outstanding at the end of the program period, an average amount of 82 percent of quota is seen. This should be compared with the cumulative limit of 300 percent. The difference is much bigger. Of course, this is only an illustration, based on a small sample, but it might be worth looking more closely into the relationship between the annual and the cumulative limit at the time of the next review.

Notwithstanding the above, in view of the highly improved prospects for the liquidity ratio, a lowering of the access limits does not seem either pressing or desirable for now. I therefore endorse the staff's proposed decision.

Having read Mr. Dorrington's statement, I cannot refrain from making the following comment. Access limits have only one purpose: to limit access, to constrain, because of concerns about liquidity over the period until the next review of quotas--which may be very far away. Accordingly, the fact that the access limits are constraining the use of Fund resources is itself no argument for increasing the access limits.

Mr. Dorrington stated that pressure on the access limits was a necessary, but not a sufficient, condition for thinking about raising them.

Mr. Lanciotti made the following statement:

There are two basic, long-established criteria for assessing Fund lending activity in general. First, the institution must remain ready to support high-quality adjustment programs that are commensurate with the financial needs of the members concerned. Second, the Fund's liquidity position in the years ahead must be preserved, so that the Fund is able to operate on a self-financing basis in the medium term.

These two criteria imply unavoidable trade-offs and call for a continuous and balanced reassessment, at regular intervals, of the access policy and the corresponding access limits. In so doing, the Fund should also continue to send the correct signal: that its role in helping members to help themselves is, and will remain, an essentially catalytic one. While the Fund should accept the fact, at the outset of promising programs, that it may need to mobilize substantial amounts of its resources in order to initiate those programs, it should also continue to expect--and require--that the relative dependence of members with Fund-supported programs on Fund financing will decline gradually, as private sources increase their participation in the process as they should.

The demand for Fund resources under arrangements over the period 1993-94 is now expected to be less than projected in the previous review undertaken in March 1993. However, the new projections remain subject to an exceptional degree of uncertainty, with regard both to the timing and the amount of arrangements, especially for those members with relatively large quotas. While the commitments under stand-by and extended arrangements have been adjusted downwards from the March 1993 projections, this is due only to the delays that are expected in concluding arrangements with a few members with relatively large quotas. Two such arrangements alone account for nearly two thirds of the total level of commitments in 1994. Also, there remains great uncertainty about the financing of ESAF arrangements, and about the magnitude of the substitution effect that might therefore be implied for commitments under stand-by and extended arrangements.

More generally, there has been some deterioration in the short-run external outlook for member countries, although their medium-term prospects have not changed much from those envisaged a year ago. For the period 1993-96, the gross financing needs of members--excluding the countries of the former Soviet Union, China, and a number of middle-income countries with large amounts of spontaneous capital inflows--are projected to be roughly the same as they were on average for the period 1989-92. However, if China and the large absorbers of spontaneous capital flows were included, but the countries of the former Soviet Union were excluded, the figure for the average gross financing needs would increase by 30 percent between the two subperiods, and by 3 percent compared with the forecast a year ago.

For some members at least, the availability of external financing has improved over the past year, especially in the case of members that implemented appropriate economic policies and that retained or regained normal relations with creditors. At the same time, the availability of market financing for most economies in transition and for many developing countries has remained limited. Further improvements in the availability of market financing flows to some members are likely to remain a gradual process.

I notice that the supply aspect of liquidity--the projected supply of usable resources--is now slightly higher than in the last liquidity review in March 1993. However, the staff notes in a footnote on page 2 of the liquidity paper that "if one or two large countries were excluded from the transfers side of the operational budget, that exclusion alone would eliminate most of the amount of usable currencies represented by the adjustment factor." I wonder whether an adjustment factor of 20 percent continues to be appropriate under these circumstances, and I would appreciate a comment by the staff on this matter.

Furthermore, I note that there has been a considerable amount of undrawn balances--SDR 5.2 billion so far in 1993--under expired or canceled arrangements. Increased liquidity could not be a cause for joy if it resulted from cancellations and inoperative arrangements with countries that most need such arrangements.

For the stand-by and extended arrangements approved since the effectiveness of the Ninth General Review, both the average annual access and the observed range have remained well within the agreed limits, even in the case of the countries in transition. I agree with the access limits treatment given to countries with access to the STF, and with the access limits treatment given to countries with accumulated rights under rights accumulation programs. While the needs of these countries and the implications for gross Fund financing should be taken fully into account in assessing the

Fund's liquidity, they should not be allowed to give a misleading picture of access determination under the limits.

In the light of the criteria recalled at the outset, and on the basis of the information provided in the staff papers, the experience so far suggests that the new access limits have not been, and do not seem about to become, a constraint on the provision of appropriate Fund support for members making adjustment efforts. Indeed, a case could be made that, even if the limits had been set at the lower levels suggested by some Directors--this chair included--during last year's discussion, they probably would not have been a constraining factor. However, we are now aware that the proposed lower limits reflected preoccupations arising from a pessimistic projection of Fund liquidity which did not materialize.

The limits finally agreed upon last year were arrived at after long discussions in the Board with a view to reconciling the differing yet legitimate concerns of Executive Directors. At the same time, the new limits were part and parcel of the other changes introduced in the overall access policy in the light of the increases in quotas under the Ninth General Review. Taking into account the information in the two staff papers about the Fund's liquidity position in the years immediately ahead, I see no compelling reason to reopen the issue of access limits at the present juncture. Nevertheless, caution should continue to be exercised, and the existing guidelines on access and the access limits should continue to be regarded as temporary and reviewed annually by the Board. With these comments, I endorse the proposed decision.

Mr. Kafka made the following statement:

We see no pressing need at this moment for a change in the guidelines on limits on access to the Fund's general resources in the credit tranches and the extended Fund facility. This is not to say that we are enthusiastic about the guidelines and limits as formulated.

While the world--outside of Asia and a few other exceptions--is still caught in a period of extremely slow growth, the Fund must take a particularly flexible attitude in applying its access policies. This must be the case not only for economies in transition, which are already benefiting, in many cases, from the STF, but for other countries as well.

I can support many of the remarks made by Mr. Schoenberg on the Fund's liquidity position, although not his rejection of the need for an early SDR allocation.

Mr. Marino made the following statement:

I agree with Mr. Dorrington and other previous speakers that the guidelines on access and access limits under the credit tranches and the extended Fund facility that were established last year have been operating relatively well. We concur that there is no compelling reason to change the access limits in either direction. Moreover, the various facilities of the Fund are already sufficiently complex, and only greater confusion would be created by changing the access limits frequently. Nevertheless, we see scope for greater flexibility in applying the guidelines on access in individual cases, given the current liquidity situation and the recessionary forces prevailing in the world economy.

We recognize that the current policy on access and access limits is intended to be temporary. Nevertheless, until Fund quotas are realigned with the actual size of payments imbalances in member countries, access limits will have to be a multiple of quotas in order to fulfil the objective of assisting effectively members that face external imbalances that are large relative to their quotas.

The external environment confronting developing countries undergoing important adjustment processes continues to be very unfavorable. The demand for their exports is weak, and the available financing for many developing countries remains severely constrained, requiring in many cases that the balance between adjustment and financing be tilted severely toward adjustment. Undoubtedly, this has implied in several cases greater adjustment costs, and has generated adjustment fatigue. The Fund should therefore facilitate the adjustment efforts of member countries through adequate financing, especially given the recessionary conditions in the world economy. In this connection, the results in terms of average effective access over the last year are disappointing. We must remember that growth-oriented adjustment programs require an adequate amount of financial support. This is the case not only for those countries that have already adopted severe adjustment programs and that still have not obtained adequate growth rates, but also for economies in transition toward a market economy.

We are all well aware of the reductions in bilateral aid from industrial countries, given the budgetary problems that many of them are confronting. Without implying that Fund resources and financing should be substituted for financing from other official sources, it seems paradoxical that, in spite of the Fund's having sufficient resources, it continues to be overly cautious when determining individual access limits. We expect to observe an increase in effective access, in order to allow countries to avoid the severe compression of imports that the adjustment effort is imposing on many of them. This has been recognized in the discussions on SDR allocations and, until a new allocation materializes, it seems that conditional Fund resources will need to play a complementary role.

In the current external environment, the Fund must be careful when determining the mix of adjustment and financing in countries with Fund-supported programs, so that an unduly recessionary bias in the required policies is not introduced. The Fund's liquidity position, as well as the current access ceilings, provide room for more flexibility when determining access in individual cases. We would hope that the Fund, while taking into account the balance of payments need, the strength of the program, and the ability to repay the Fund, would also recognize that orderly, growth-oriented adjustment may in many cases require greater financing.

We are encouraged by Mr. Dorrington's statement of his willingness to consider higher access limits if conditions warrant it.

Mr. Geethakrishnan stated that, at the time of the previous review of access limits, his chair had supported the decision to set the annual limit on access to the Fund's resources at 68 percent of quota, and the cumulative limit at 300 percent of quota. At the same time, his chair had agreed to the provision that, within the limits, actual access in individual cases would be determined in accordance with the criteria already established by the Board. As indicated by the staff, those limits had provided sufficient scope for the Fund to support adequately the adjustment efforts of members. Given the continued need for the Fund to support members' adjustment efforts while maintaining a strong liquidity position, it seemed appropriate to maintain the access limits in the year ahead. As Mr. Dorrington had rightly pointed out, it was not desirable to make frequent changes in the limits on the basis of changes in circumstances that might prove to be short-lived. He therefore had no hesitation in endorsing the proposed decision.

Although the annual and cumulative access limits appeared adequate, he felt a bit uneasy about the way access had been determined in individual cases, Mr. Geethakrishnan stressed. While the limits should not be treated as targets, the data clearly indicated that average annual access had been considerably less than the limit set. The situation had actually worsened in the time since the setting of the new limits in November 1992. Average annual access in the 12 arrangements that had been approved between November 1992 and mid-September 1993 have been only 31 percent of quota, against the limit of 68 percent of quota. Moreover, in seven cases, the actual amount of access had been much less than 31 percent of quota, with the lowest being only 18 percent.

He would have been satisfied if in those cases the members' need for Fund financial assistance had been met, taking into consideration as well the catalytic nature of Fund financing, but he was not assured of that, Mr. Geethakrishnan continued. Given the world economic environment and its impact on most of the developing countries, he would hesitate to agree with the staff assessment that access had been moderate because the adjustment process had been well advanced and the need for balance of payments assistance therefore limited. He also doubted that the decline in the provision of Fund financing reflected the reform efforts of members taking hold, thereby enabling them to re-establish access to other sources of financing, private as well as official. He also believed that the staff's assumption of the financing requirements of members was underestimated. For example, in many cases, the unit value of exports and the evolution of the terms of trade had turned out to be worse than the staff's projections. There had also been several cases in which the flow of aid and other assistance, both multilateral and bilateral, had been much below the assumptions.

While the flow of private capital had increased for some countries, it was not true for the majority of the developing countries, Mr. Geethakrishnan concluded. It was therefore not surprising that, in many cases, programs had gone off track, or required modification. While there was no need to change the limit, therefore, he would urge the staff to be more realistic in making assumptions, and more flexible and liberal in assessing the financing requirements of developing countries. Past experience showed that it would be prudent to be a bit more pessimistic about the prospect of aid flows, the terms of trade, and the flows of private sector funds.

Mr. Wei made the following statement:

> I welcome this opportunity to have the first annual review of the current access policy and limits under the credit tranches and the extended Fund facility, which was introduced following the effectiveness of quotas under the Ninth General Review. Today's review is important in view of the continued uncertainty in the world economy, and the volatility that will have an impact on the Fund's usable resources. As indicated in the staff paper, although only relatively limited experience has been gained so far in implementing the new access policy and limits, both the annual and cumulative limits remain appropriate, as in practice they do not impose constraints on the provision and use of Fund resources. I share the staff's overall assessment and description of the issues bearing on the access policy and limits. I therefore have no difficulty in supporting the proposed decision.
>
> Three factors should be taken into account in reviewing the policy at present. First, there is certainly an expected increase in member countries' financing needs, not only for those in the process of implementing bold adjustment and stabilization programs, but also for those experiencing spontaneous capital inflows. The staff has now projected member countries' financing needs for 1993-96 to be about 3 percent higher than the forecast

made a year ago. Second, financing needs are difficult to project owing to the high level of uncertainty attached to global economic growth. In this regard, I share the concern that the spontaneous inflows experienced by some developing countries may not be sustained at present levels. Third, the Fund is playing an increasingly important role in assisting developing countries with their macroeconomic adjustments, including those economies in transition, which will require inevitably that the Fund stand ready to extend financial and technical assistance to meet the formidable challenges confronting them. A recent example is the timely establishment of the STF to assist the economies in transition.

All these considerations lead this chair to maintain its view that the access policy and limits should be set to accommodate members' financing needs, without jeopardizing the Fund's liquidity position. Also, as much as possible, the access limits should embody the principles of continuity, stability, and simplicity. We concur with the staff that it is of vital importance to maintain the exceptional circumstances clause, which provides members with the flexibility, on a case-by-case basis, for increasing access in order to support their adjustment efforts.

Under the present access limits policy, gross Fund financing has averaged only about 8 percent of members' projected gross financing needs. Given that many countries have undertaken bold and comprehensive adjustment and reform programs, and taking into account the fact that these countries are seeking the Fund's financial assistance at the crucial initial stage of their economic problems, any reduction of the access limits will send a negative message to the international community. It would also reflect poorly on the Fund, given that one of the Fund's most important objectives is to support members' economic adjustment efforts.

Although the Fund's liquidity position at present is sufficiently strong, owing mainly to the recent effectiveness of the new quotas under the Ninth General Review, the staff nevertheless forecasts a steady decrease in the liquidity ratio, to 90 percent by end-1996. Therefore, the staff rightly warns the Executive Board to monitor closely those developments that could either increase or reduce the demand for Fund resources. The projected fall in the liquidity ratio underscores, inter alia, the urgent need to strengthen the Fund's financial position. In this connection, we urge an early start to the Tenth General Review of Quotas and an early conclusion of the issue of financial contributions to the ESAF successor.

Mr. Zoccali made the following statement:

It is comforting to learn that the Fund's liquidity ratio now stands at the historically high level of 164 percent, and that the initially projected decline--to some 33-50 percent by end-1995--that colored our deliberations leading to the establishment last November of new access limits to broadly maintain the level of potential access following implementation of the Ninth General Review of Quotas, is now envisaged to be much slower, to around 110 percent by that date. This said, we also subscribe to the notion that access limits should not be set exclusively on the basis of the liquidity ratio.

The continuation of recent experience regarding the provision of Fund financing in absolute terms has contained effective annual access in individual cases to an average of 31 percent of quota--less than 46 percent of potential access. Even including the associated purchases under the STF and the compensatory and contingency financing facility (CCFF) as a proxy for the exceptional circumstances clause, gross Fund financing has averaged only 8 percent of a member's projected gross financing needs. It should not come as a surprise, therefore, that our policy on access limits has also contributed to the liquidity scenario described in the staff papers.

It is less clear, however, that existing access limits and the levels effectively applied signal the adequate availability of support for members' adjustment efforts for the future, in particular in the context of a further short-term deterioration in external prospects and the continued deceleration of world trade volumes. The relatively low quotas in relation to potential need, and the more comprehensive structural requirements for stability and growth in many member countries, could even make a case for more meaningful access to conditional Fund resources, to help sustain both the quality and the momentum of adjustment, and in order convincingly to catalyze other forms of support, especially private flows.

Given the Managing Director's proposal to address soon the working of the quota formulae and the concerns regarding distribution and adequacy of quotas in the Fund, we can go along with the consensus that current access limits be maintained for the coming year. Nevertheless, it remains in our view essential that the Fund maintain appropriate flexibility regarding committed undrawn access and new use of Fund resources, in particular if the downside risks in respect of somewhat faster growth in industrial countries as a group for 1994 materialize, or if the Uruguay Round of trade negotiations cannot be concluded satisfactorily by the end of the year.

Mr. Abbott made the following statement:

This chair was one of those that believed that the access limits agreed last year were overly generous. That is still our bias, but we can support today's proposed decision. We do not believe that conditions have changed since last November's discussion in a manner that would warrant a revision in access levels.

Under current circumstances, the major question that must be answered in approaching this issue is whether or not the Fund is fulfilling its catalytic role under current levels. Clearly it is, as evidenced by the 8 percent share of gross financing needs met by Fund lending. As the staff notes, this share is broadly in line with the average for recent years, and it was met through lending programs which, on average, disbursed less than half of the annual access level. This suggests a comfortable margin--within current access limits--for providing a larger relative share of Fund financing, where necessary. Indeed, for some countries--notably, the economies in transition--higher access levels have been provided. Even in these cases, a comfort margin was still maintained, however, owing to the establishment of the STF, which has provided additional, substantial access outside of the credit tranches. In sum, we share the staff's conclusion that annual access limits have not acted to limit the Fund's ability to provide appropriate support. Even if isolated cases were to arise, the exceptional circumstances clause is available.

Mr. Sirat indicated that the workability of the new access limits has not really been tested. This is a fair observation, but the liquidity calculation indicates that the Fund is in a secure position to withstand much more severe tests. As long as the Fund is comfortably fulfilling its traditional catalytic role within the current access limits, and is expected to be able to continue to do so, the improved liquidity position is not an argument for expanding access limits, even though it is an argument for looking more closely into the analytical basis for the estimation of liquidity ratios.

On this point, I agree with most of what Mr. Schoenberg said about the arguments used in calculating the liquidity ratio going forward, in particular with respect to the potential need for additional liquidity by countries that have experienced surges in capital inflows. It seems to me that the surge in capital inflows resulted in an expanded current account deficit--which allowed the inward transfer of resources to take place. If it is a temporary surge, then an adjustment on the current account would be called for, not more financing. This issue is not well presented in the analysis of the liquidity ratio projections.

In reading the paper on Fund liquidity, one is struck by the medium-term liquidity forecasts, which put liquidity ratios at historically high levels through the end of the period under review. Moreover, the estimates do not assume an ESAF successor, and so include significant lending of ordinary resources to ESAF-eligible countries--nearly 20 percent of estimated commitments in 1994; that is unlikely to occur.

The ample stock of usable resources anticipated over the medium term should lay to rest any thought that a quota increase will be needed in the foreseeable future, especially when the expansion of global capital markets and their greater integration with the countries in transition and the developing countries is taken into account. The Fund's ability to provide sufficient conditional resources from the current quota pool over time is thus even more evident.

Mr. Bergo made the following statement:

My authorities are in broad agreement with the thrust of the staff analysis, and support the proposed decision. My authorities have emphasized in the past that the Fund must continue to play a meaningful role in providing adequate financial assistance within an appropriate policy framework. At the same time, my authorities have stressed that access limits should be prudent with respect to the Fund's liquidity position.

The current access limit policies strike an appropriate balance between liquidity considerations and the need to provide adequate financing. With the current liquidity position being quite comfortable, the question may arise--as it indeed has--as to whether this would warrant a more generous access limit policy. However, as pointed out by many Directors, in light of the fact that the current access limits have been nonbinding, and are likely to be so in the near future, it appears that the appropriate decision is to maintain the current limits until the time of the next review by the Board. In view of the volatility of the current status of many prospective recipients of Fund resources, and the uncertainties of the liquidity projections, developments should be kept under continuous observation, and, should the situation so merit, the next review held at an early date.

It is conceivable that a situation will emerge in which relatively fewer recipients of Fund resources will require a larger share of those resources. Should that happen, the Fund should stand ready to review its access policies. However, as pointed out by Mr. Dorrington, there should be no need to make a general change in access limits to deal with isolated special cases.

Mr. Mozhin made the following statement:

Today is the first time that this chair has had an opportunity to comment on the issue of Fund access policy and limits under the credit tranches and the extended Fund facility. The staff paper on the Fund's liquidity and financing needs makes it clear that there is room for an increase in access limits. There are a number of reasons for such a conclusion.

First, the paper clearly demonstrates that the Fund's stock of usable resources and liquidity ratio are currently at peak levels, while the Fund's reserves have also reached record levels. At the same time, the situation of overdue financial obligations to the Fund has improved markedly. Total outstanding Fund credit at the end of this year is expected to be SDR 30.3 billion--that is, below the level of 1987, when the total of Fund quotas was SDR 90 billion, or SDR 54.7 billion smaller than it is at present. Against this background, the projected net increase in members' use of Fund resources in 1994 of SDR 1.8-3.4 billion will only marginally affect the strength of the Fund's liquidity position, which will remain at a historically high level. Therefore, the staff correctly concludes that "there continues to be little doubt that the Fund is well able to meet both the projected substantial demands on its resources over the next few years as well as ensuring the liquidity of members' claims on the Fund."

Second, the new staff projections, like those made in March 1993, tend to be on the conservative side. It is true that liquidity ratio projections are subject to a very high degree of uncertainty, as the staff notes in its concluding remarks. I also agree with the argument that the Fund's heavy dependence on a few large industrial and developing countries for its supply of usable resources makes it somewhat vulnerable. Yet, in the near term, the risks associated with excluding those currencies from the operational budget seem insignificant. They are more than offset by the 20 percent downward adjustment of the amount of usable resources contained in the liquidity ratio projection originating in, first, the potential effects of the establishment of an ESAF successor, and second, the continued drawdown of the Fund's SDR holdings for the purpose of financing members' purchases. The latter factor may very well lead to a further decline in the total projected liquid liabilities of the Fund, resulting in a liquidity ratio much better than the ratio of 129.4 percent currently projected by the staff for December 1994.

Third, potential changes in the Fund's access policy and limits under the credit tranches will have only marginal effects, if any, on the Fund's liquidity position and financing needs, because access is determined on the basis of a set of specific criteria and in light of balance of payments need, the strength of the program, and the ability of the member to repay its debts to the Fund. Therefore, in assessing requests for Fund financing, the access limits are regarded neither by the Fund nor by its members as representing an entitlement.

According to the staff paper on the review of access policy and limits, since the establishment on November 3, 1992 of a new limit on annual access in the credit tranches and under the EFF at 68 percent of quota, a dozen stand-by and extended arrangements have been approved by the Executive Board, with annual access averaging just 31 percent of quota, with none of the approved amounts exceeding 48 percent of quota. As the average of 31 percent of new quotas compares with the average of about 49 percent of old quotas under the enlarged access policy in the period 1986 through end-October 1992--during which time the access limits were unchanged--this comparison suggests that there was even a slight decline in absolute terms.

At the time of discussion of the previous paper on access policy and limits a year ago, in which this chair unfortunately did not participate, the staff estimated the possible commitment of Fund resources to the countries of the former Soviet Union at about SDR 13.5-17.5 billion, and total new Fund commitments at SDR 36-42 billion during 1992-95. On that basis, the staff predicted that the Fund's liquidity ratio would fall to some 33-50 percent by end-1995. Now we have a new set of staff projections indicating that total new commitments to all members in 1992-95 is likely to be of the order of SDR 26 billion--including SDR 9 billion for the countries of the former Soviet Union--with the liquidity ratio estimated at about 110 percent by end-1995.

Such is the magnitude of the revision of the staff estimates that there is no doubt that on the supply side there is the possibility of an increase in access limits. The next question is whether such a step would be warranted from the point of view of the demand for Fund financing. Again, I believe that the answer is yes. I will not repeat all the relevant arguments, since many of them have been raised many times in connection with the issue of a new SDR allocation. Let me just draw your attention to the new staff paper on financial relations among countries of the former Soviet Union, which is scheduled for discussion on December 1, 1993. The main conclusion of this paper is that, in 1994, most of the countries of the former Soviet Union will experience another very severe terms of trade shock, which will require very substantial external financial assistance to those countries to enable them to cope with it.

Ms. Langdon made the following statement:

Like several previous speakers, we agree that the Fund's access policy is working well. The Fund has been, and will continue to be, able to provide adequate support for the adjustment efforts of deserving members, including the economies in transition, without undue strain on its liquidity position. Current access limits are also not expected to constrain in any significant way the provision of Fund financing. While the staff estimates that a few members could become access constrained by end-1996, we agree with Messrs. Abbott and Dorrington that should this arise and be a problem, it could be addressed through the exceptional circumstances clause.

Therefore, we can support the staff's recommendation to retain the existing limits for the coming year, to ensure that there is ample scope for members with sufficiently comprehensive macroeconomic adjustment programs to obtain adequate Fund support for their efforts.

This latest review of the Fund's access policy strongly supports the view that the Fund's conditional resources are more than adequate to meet prospective financing needs of members through end-1996. Thus, my authorities are drawn to make an observation somewhat similar to that of Mr. Schoenberg concerning an SDR allocation with a redistribution mechanism. Furthermore, and in a prelude to next week's discussion on the work program, the comfortable outlook for the Fund's liquidity position suggests that full-blown discussions on the Tenth General Review of Quotas certainly should not be an immediate priority.

Mr. Shaalan made the following statement:

I welcome this first review of the new guidelines on access policy and limits following the quota increase. In reviewing access policy, we should keep in mind the need to safeguard the Fund's financial position, and the need for the Fund to be able to provide adequate support for the adjustment efforts of member countries. With respect to the former, the staff paper projects the Fund's liquidity ratio to decline more slowly than projected at the time the new guidelines were established in October 1992. Indeed, the liquidity ratio is now envisaged to decline to only 110 percent by end-1995 compared with 164 percent as of end-August 1993. It is to be recalled that earlier projections put the liquidity ratio at 35-50 percent by end-1995. These estimates are subject to a very high degree of uncertainty, in particular as regards the commitments to the countries of the former Soviet Union, which continue to represent a large proportion of total projected commitments. Nevertheless, I have sympathy for some of the other Directors' concerns about the dramatic changes and frequent underestimation of the Fund's liquidity position. There is no doubt that projections of the Fund's liquidity position should be made using conservative or cautionary assumptions, in particular in light of the importance of safeguarding the financial position of the Fund. However, it is also necessary to make realistic assumptions so as to allow the Board to adequately analyze the access policy.

Regarding the financing needs of members, the balance of payments needs are projected to increase compared with the forecast in the fall of 1992. This is not surprising, since the recent surge in private capital inflows to developing countries is unlikely to be sustained at its present level--as was noted on several occasions this year in the context of the Board's discussions on international capital markets--especially as the recovery in industrial countries takes hold and interest rates rise. However, in this context, and like Mr. Schoenberg, I believe that the likely increase in exports of developing countries to the industrial countries should be taken into account.

The above considerations suggest that the current access limits are generally appropriate, in particular as experience thus far with access in individual cases implies that both the annual and cumulative access limits have not been a constraint on the provision by the Fund of appropriate support for members' adjustment efforts. Accordingly, I can support the proposed decision to maintain the current access limits for the next 12 months before the next annual review.

Mr. Cippa made the following statement:

This chair approves the proposed decision to leave the current policy on access to the Fund's resources unchanged for the coming year. The experience so far has shown that the limits set up last November are not unduly low. They have proved appropriate to permit the Fund to provide the necessary financial support for the adjustments of individual member countries, while maintaining its share in the gross financing needs of members at about the average of past years. We believe that this proportion is adequate and broadly consistent with the catalytic role that the Fund is called on to play.

We agree with the staff analysis both with respect to the revised projections of the balance of payments needs of member countries--in line with the latest world economic outlook exercise--and the outlook for the Fund's liquidity through 1995. The fact that the liquidity ratio is now projected to decline more slowly than expected earlier is due mainly to the difficulties encountered by many countries, especially the countries of the former Soviet Union, in formulating and sustaining Fund-supported arrangements. One must hope and expect that this situation will change soon and that these countries will be able to implement credible economic adjustment programs, meaning that the current comfortable liquidity position of the Fund will be only temporary.

For that reason, we would advocate some caution in pursuing larger access to Fund resources. Moreover, I fully endorse Mr. Dorrington's comment that a more comfortable liquidity position is not in itself an argument for an increase in access limits, as long as they do not inhibit the Fund from playing its proper role, either now or in the near future. The staff analysis proves that this is not the case for the time being.

Our desire to leave the access policy unchanged for the coming year does not imply that we are not prepared to resort to the exceptional circumstances clause in order to accommodate the exceptional financing needs of member countries on a case-by-case basis.

Mr. Kabbaj made the following statement:

We welcome this review of access policy. We fully agree with the staff proposal and we can support the proposed decision.

At this critical juncture for the world economy, it is important that the Fund be seen by the international financial community--as well as by its membership--as willing and ready to contribute its share to the process of macroeconomic adjustment and the revival of growth. Any reduction in access limits would be inconsistent with this overriding necessity; on the contrary, such a reduction would give the wrong signal to those who are striving to make these objectives a reality.

The facts and figures in the staff paper amply demonstrate the wisdom of maintaining the present limits, which are far from being used to their full extent. As pointed out by many previous speakers, the actual average annual access since November 3, 1993 stands at less than half of the 68 percent of quota that was allowed under the access policy following the effectiveness of the quota increases under the Ninth General Review. It is indeed questionable whether such a cautious implementation of the policy is not going too far, especially taking into account the proportion of members' financing needs that the Fund provides--which did not exceed 8 percent. Similarly, maximum cumulative access is far from being used, and there have been no occasions on which the exceptional circumstances clause was resorted to.

The outlook for the Fund's liquidity position has improved compared with earlier projections, as a consequence of the way the policy was actually implemented and the slow progress in some of the countries of the former Soviet Union in the formulation and implementation of adjustment programs. Another reason for this more favorable outlook is the graduation from, or reduction in the use of, Fund resources on the part of heavy users of Fund resources in the past decade.

Despite all the preceding elements, we would caution against a further premature reduction in nominal access limits, and we would call for a more liberal implementation of access policy if the catalytic role of the Fund is to be fulfilled. The uncertainties surrounding the world economy, together with the ongoing difficult process of rehabilitation of economies in transition, make it imperative for the Fund to continue to be able to intervene at an early stage of possible difficulties; hence, the usefulness of some room for maneuver.

We are prepared to review the guidelines and limits on members' access to the Fund's general resources under the credit tranches and the extended Fund facility one year from now.

Mr. Koissy made the following statement:

After considering carefully the relevant factors bearing on access policy--the global economic outlook, the prospective financing needs of member countries in support of their adjustment efforts, and the Fund's comfortable liquidity position--the staff has concluded that the current access limits remain adequate, and that they will not constrain the Fund's ability to assist its members. Although this chair, like Messrs. Dlamini and Wei, would have preferred raising these limits in view of the still difficult world economic environment and the prospect for increased balance of payments needs of developing countries, we can nevertheless go along with the proposed decision.

Mr. Prader made the following statement:

The staff argues persuasively that there is no obvious reason for changing the access policy or the annual and cumulative access limits under the Funds credit tranches and the extended Fund facility. After almost a year's experience with the access guidelines adopted in November 1992, I can agree with the staff that the existing access limits deprive neither the Fund's members of its financial assistance, nor the Fund of its important role in assisting adjustment and catalyzing further financing. The figures on members' actual use of Fund resources, expressed as a percentage of their quotas, show that access limits do not presently operate as a binding constraint on the financial assistance a member can obtain to support its adjustment efforts.

However, this outcome is due partly to a relatively strong balance of payments performance on the part of some countries, and to a lower than optimal adjustment effort on the part of others. Those factors also explain why drawings on the Fund have fallen short of projections in recent months. Thus, even though the current access limits are adequate, as long as other factors are acting as the binding constraint on members' access to Fund resources, our access policy reviews should still monitor closely both the course of members' adjustment efforts and the conditions in the world economy. Nevertheless, in the absence of major changes in the conditionality applied to access to Fund resources, we can be confident that the existing access limits will allow the Fund to do the best it can to assist the adjustment efforts of member countries. I therefore support the proposed decision.

Mr. Lee made the following statement:

I agree with the staff assessment that the current access limits have not constrained the Fund's ability to provide adequate financial support to members with balance of payments needs. Of course, access limits are only one part of the overall framework for providing such assistance. Another part is the facilities themselves, and here we have recently shown flexibility in assisting our members facing the greatest need through the use of the STF.

It is comforting to note that the rapid decline in the Fund's liquidity ratio that was projected at the last review now appears unlikely to occur, and that the liquidity position of the Fund is now likely to remain at quite comfortable levels for the next two years or so. While recognizing that arguments exist for both an increase and a decrease in access limits, I can agree to the maintenance of current access limits. I therefore support the proposed decision.

Mr. Ismael made the following statement:

I also can support the proposed decision to maintain the current access limits, based on the following three factors. First, circumstances have not changed sufficiently during the past year to justify a change in access limits; second, the Fund's liquidity position is relatively comfortable and much stronger than expected a year ago, facilitating the Fund in performing its role; and third, the present access limits have provided adequate support to adjustment policies required to restore members' macroeconomic stability and economic growth.

Mr. Al-Jasser made the following statement:

> An appropriate access policy must satisfy the need of the Fund to preserve an adequate liquidity position, and, at the same time, provide appropriate support for the adjustment efforts of the Fund's membership. The access policy that we adopted last year following the quota increase appears to have satisfied both objectives. The liquidity ratio is projected now at a comfortable level of 110 percent by end-1995, compared with last year's projection of 35-50 percent. Furthermore, the staff paper notes that "overall, it would seem that the annual access limit has not been a constraint on the provisions by the Fund of appropriate support for members' adjustment efforts." Thus, I have no problem in supporting the proposed decision, and I am in general agreement with the thrust of the staff paper.
>
> The primarily catalytic role of the Fund in financing the adjustment efforts of countries cannot be overemphasized. Therefore, it is surprising that the word "catalytic" does not occur in two important sections of the staff paper, namely, in the section on the role of the Fund and in the conclusions.
>
> I agree with Messrs. Cippa and Dorrington that a more comfortable liquidity ratio is in itself not a cause for raising access limits. However, like a number of speakers, I note the sharp fluctuations in the projections of the liquidity ratio. While I fully agree that caution is imperative when making such projections, and while I recognize the substantial uncertainty under which the Fund must operate, especially given its increased involvement in the countries of the former Soviet Union, the large and systematic underestimation of projections of the liquidity ratio is of concern. I mention this only because I believe that the liquidity exercise is very important, and that its credibility should not be undermined.

The Deputy Director of the Policy Development and Review Department stated that Messrs. Abbott, Schoenberg and Shaalan had questioned the use of the projections of gross financing needs in the framework of trying to estimate demand for Fund resources. The staff had prepared the projections as part of the international economic framework in which the Fund operated, and for purposes of maintaining consistency with the approach the staff had taken in the past. As Mr. Schoenberg had noted, changes in the projections were attributable largely to positive developments in the cases of a few countries, in particular with regard to their regaining access to spontaneous capital flows. In that circumstance, a change in projections of gross financing needs might have little relevance for demand for exceptional Fund financing. More generally, the staff had had some hesitation about using the concept of gross financing needs as a means of assessing future demand for Fund resources, and it was clear that more attention would need to be devoted to the issue. If more and more countries regained access to spontaneous capital inflows, the concept of gross financing needs, as measured in the World Economic Outlook and included in the papers on the review of access limits, was likely to have a more tenuous bearing on potential demand for Fund resources.

To maintain average annual access at about 31 percent of quota overall was by no means a staff objective, the Deputy Director stressed. Rather, the staff considered access in individual cases in the light of the various criteria: the country's particular situation and balance of payments needs, the strength of its program, and the availability of other resources. The staff had attempted to determine the appropriate level of access in that framework in individual cases. He had noted Mr. Geethakrishnan's point about the need for realism in projecting the evolution of external factors, and the staff was conscious of the vulnerability and the risks. The staff continued to try to improve the quality of the projections in individual cases. The average annual access of 31 percent of quota had come about as a result of the particular set of countries--and their needs--that had come forward with Fund-supported programs in 1993. A quite different average could be contemplated if the country composition had been different, and he would expect a different average in the future. In reaching judgments on access in individual cases, the staff was not trying to manage the overall situation toward a particular objective.

The staff representative from the Treasurer's Department stated that there were two reasons for the large changes that had occurred over the preceding year in the staff's liquidity projections for the period 1992-95. One was the evolution of events in the countries of the former Soviet Union, and the other, the impact of assumptions regarding the provision of Fund financing to large countries.

The staff believed that the question of timing was a key one in assessing the financing for the countries of the former Soviet Union, the staff representative commented. One year ago, the staff had assumed that most of the countries of the former Soviet Union would have stand-by arrangements in place, to be followed by extended arrangements, in the period 1992-95. The current expectation was that those countries would make purchases under the STF, thus postponing extended arrangements and probably extending them over a longer time period. In consequence, demand for Fund resources on the part of the countries of the former Soviet Union was likely to occur later than presumed--possibly even later than 1996. While demand for Fund financing was not being reduced, it was being stretched out over time. There were many difficulties in estimating demand as far into the future as 1996 and beyond, not only because of the problem that Mr. Schoenberg had identified of using gross financing needs as an indicator, but also because of the uncertainty surrounding the extent to which a larger amount of financing that might be needed by some of those countries under extended arrangements would be offset by a diminished need for financing in other countries with strong capital inflows, reflecting their strong reform efforts. On balance, however, the staff believed that demand for Fund resources was likely to be at the same level, on average, as in the preceding few years.

Two or three large countries played a very significant role in the estimations, the staff representative continued. Any change in the timing of the discussions or the implementation of policies in those countries tended to affect the projections substantially. The improved positions of a number of countries with capital inflows had lowered the estimates of Fund financing. The use of Fund resources by other countries was currently projected to be lower, as some members had made substantial progress in their adjustment efforts, and there had been a resurgence of spontaneous private capital inflows to them. Also, a large number of arrangements had become inoperative, releasing a large amount of resources; that had not been anticipated earlier. Finally, country-by-country estimates of demand for the CCFF for 1994 had been unavailable at the time of the drafting of the staff papers. As those estimates were beginning to become available, it appeared that total CCFF purchases for 1994 might well be significantly larger than the SDR 0.8 billion that the staff had been projecting.

The supply side of Fund financing--the currencies that could be used in the operational budget--was particularly vulnerable, the staff representative observed. A number of countries the currencies of which were considered usable at present had substantial current account deficits and balance of payments difficulties, which might lead to the exclusion of at least one or two of them over the coming quarters.

While the long-term staff projections of financing needs might be problematic, a much better experience could be seen with projections extending over a period of less than 18 months, the staff representative noted. The deviations were within an acceptable range for shorter-term projections.

Because of the deteriorating balance of payments positions of some of the countries the currencies of which were at present considered usable--in particular, with respect to one or two large countries--the staff had used an adjustment factor of 20 percent--of SDR 12.4 billion--in projecting the amount of usable currencies in the period ahead, the staff representative from the Treasurer's Department concluded. The staff believed that such an adjustment factor would be adequate to deal with the uncertainty surrounding the amount of usable currencies in the operational budget. Of course, reviews of the Fund's liquidity were held every six months, and if at those times any currencies were to be excluded, the adjustment factor would then be reassessed. The staff would keep the matter under close review in the context of the reviews of the Fund's liquidity and the quarterly operational budgets.

Mr. Shaalan commented that the projections of the liquidity ratio by the end of 1995 had fluctuated from 35 percent to 110 percent. Given such sizable fluctuations, he could not go along with the view of Mr. Abbott and Ms. Langdon that the present liquidity ratio indicated that there was no need to move ahead expeditiously with the Tenth General Review of Quotas. The justification for the timing of the next review could not be based on projections that had been subject to such wide fluctuations.

Mr. Abbott replied that while he had no objection to going ahead with reviewing quotas under the Tenth General Review, the projections did not foreshadow the need for an increase in quotas, in his view.

Mr. Shaalan commented that the fact that the projections fluctuated widely did not necessarily mean that no increases in quotas were needed.

Mr. Abbott observed that while the forecasts tended to fluctuate widely, the outcome usually did not.

Mr. Al-Jasser said that the forecasts of the liquidity position had generally been off the mark on the low side, which had been in keeping with the staff's conservative approach. While there were drawbacks to such an approach, that did not necessarily strengthen the case to adopt an overly bold approach instead.

The Executive Directors adopted the following decision:

> Pursuant to Decision No. 10181-(92/132), adopted November 3, 1992, the Fund has reviewed the guidelines and the access limits for access by members to the Fund's general resources under the credit tranches and the extended Fund facility, and decides that they remain appropriate in the present circumstances.

Decision No. 10500-(93/148), adopted
October 27, 1993

2. REPUBLIC OF ESTONIA - REQUEST FOR STAND-BY ARRANGEMENT; AND USE OF FUND RESOURCES - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on the Republic of Estonia's request for a 17-month stand-by arrangement in an amount equivalent to SDR 11.625 million and on Estonia's request for an initial purchase under the systemic transformation facility (STF) in an amount equivalent to SDR 11.625 million (EBS/93/166, 10/8/93; Cor. 1, 10/13/93; and Sup. 1, 10/21/93).

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

> Preliminary information suggests that the September 1993 indicative targets for the General Government's financial deficit and net lending, the net international reserves of the Bank of Estonia, and reserves of the banking system, as well as limits on external debt, were all met by comfortable margins.

Monthly consumer price inflation accelerated from 0.7 percent in August to 3.0 percent in September. The higher than expected inflation partly reflected rising import prices, especially from the countries of the former Soviet Union--which increased in response to the sharp real appreciation of the ruble against the kroon during July and August. Other exceptional factors included the increase in some administered prices--transportation--and selected seasonal price increases--winter clothes, sugar, and school supplies.

The average monthly wage rose by 1 percent in August and 2.2 percent in September. Since March 1993, the cumulative increase has been 11.5 percent, while consumer prices have risen by 12.2 percent; as a result, real wages during this period have remained broadly unchanged.

Industrial production declined somewhat in July and August, reflecting the summer holiday season, but then recovered by more than 10 percent in September. The most recent business survey suggests that the recovery is likely to continue at least through the end of the year.

The Government introduced the 1994 central government budget to Parliament on September 30. The proposed budget is in balance and is consistent with the performance criteria of the program.

Base money increased by 17 percent, or 10 percent in real terms, and broad money by 19 percent, or 12 percent in real terms, during the third quarter of 1993. Domestic credit grew by 19 percent during the third quarter of 1993, with credit to the private sector rising by 40 percent and credit to state enterprises falling by 1 percent. The increase in credit to the private sector represents a recovery in activity following the decline in credit in real terms during the November 1992 bank crisis.

The balance of merchandise trade registered deficits of $2.7 million in July and $5.9 million in August, reflecting mainly an increase in imports, as projected by the staff. Meanwhile, gross international reserves rose by $76 million during the third quarter of 1993, reaching $351 million at end-September 1993.

Mr. Bergo made the following statement:

More than a year has now passed since Estonia launched its stabilization and reform program supported by its first stand-by arrangement with the Fund. All quantitative performance criteria under the arrangement have been met, and all purchases have been made. On the whole, developments have been encouraging, and the Estonian authorities believe that it is crucial to continue to implement a strong and consistent stabilization and reform program so as to consolidate the gains already made, and to lay a strong base for sustained growth in the period ahead. In this context, Fund support is regarded as vital in enhancing domestic and international credibility for the program.

As Directors will recall, the first program focused on macroeconomic stabilization, the cornerstones of which were maintaining fiscal balance, preserving the integrity of the currency board and completing the price liberalization. The Estonian authorities have shown their strong commitment in pursuing consistent and stringent reform policies, and major achievements have been realized in many areas. In the words of Prime Minister Mart Laar, speaking on the anniversary of the Estonian kroon in June 1993, "the first year of the kroon can truly be called a period of economic revolution. During this short time, Estonia has changed beyond recognition."

One crucial factor in gaining economic stability has been confidence in the kroon. The kroon has been strong and was not materially affected by the banking crisis that emerged in November 1992. The crisis was resolved, and confidence in the banking system largely restored. Needless to say, throughout the program period, the kroon has been supported by tight fiscal policy. Progress has also been made in modernizing banking legislation, with the recent passage of the Central Bank Law, which provides the Bank of Estonia with a substantial degree of independence.

Price liberalization was nearly completed by late 1992; and, since then, Estonia's inflation has decelerated rapidly, to a range of about 2 percent monthly, and there is a good chance that inflation will be less than 30 percent this year. Furthermore, the authorities believe that single-digit inflation is within reach in 1994. The pickup of consumer price increases in September to 3 percent, following the record low monthly rate of inflation of 0.7 percent in August, can be attributed to a large extent to seasonal factors and to the recent appreciation of the Russian ruble.

The focus of the new program is on a macroeconomic framework that permits an early return of sustained growth, and which will bring the rate of inflation down close to Western European levels. This will be achieved by continuing tight fiscal policies, maintaining the integrity of the monetary policy, and reducing rigidities in wage and price formation. The Government also intends to accelerate the pace of structural reforms to allow the private sector to contribute to the recovery of growth, and to further reduce the role of the state in the economy. The program is clearly described in the authorities' memorandum of economic policies and in the staff paper, so let me highlight only some of the key elements.

Estonia has succeeded in maintaining budgetary discipline and balance in its fiscal policy, in spite of strong pressures for expenditure increases. Unfortunately, this has been possible only by cutting expenditure on public investment. Recently, the Government presented a balanced draft state budget for 1994 to the Parliament. The major sources of revenue are the value-added tax and the income tax, both of which are under revision. The authorities intend to lower personal income taxes, as well as the enterprise profits tax. These actions will lead inevitably to some decline in revenue, which is to be balanced by restraining public spending.

In the context of the 1994 budget, the Government will continue to refrain from providing subsidies or subsidized loans to enterprises. The only budgeted subsidies will be the heating subsidies for consumers. Furthermore, the Government is planning to break up the monopolies in the electricity and oil shale industries, and possibly privatize those companies.

The authorities acknowledge the urgent need for public investment in infrastructure. In collaboration with the World Bank, a Public Investment Program for 1994 is expected to be finalized by the end of the year. It would be funded primarily by the World Bank and the European Bank for Reconstruction and Development (EBRD). An External Financing Board (EFB) has been set up to coordinate the lending activities.

The transition to a market economy places a heavy burden on the social security system. The Government intends to continue to strengthen and rationalize the social safety net with technical assistance from the World Bank. The objective is to ensure that aid is channeled effectively to the most vulnerable groups of the population within the constraints of the overall budgetary objectives.

The main task of monetary policy--along with maintaining the strict integrity of the currency board arrangement--is to further improve the performance and stability of the banking system, so that the commercial banks can better act as the financial intermediaries of the business sector. Even if decisive action by the authorities following the banking crisis sufficed to restore confidence, the authorities will give the highest priority to strengthening the banking system. Important measures to this end are set out in paragraph 27 of the memorandum of economic policies. Furthermore, the authorities recognize the importance of maintaining a commercial banking system that is owned predominantly by the private sector, and they will implement measures to that effect within a period of one year.

The authorities recognize that the introduction and maintenance of a very liberal trade policy and payments regime have been important factors behind the economic progress, and have brought about a substantial internationalization of the Estonian economy. Accordingly, the Government and the Bank of Estonia are committed to maintaining Estonia's liberal trade and payments regime and to introducing further liberalization measures. As sufficient confidence has already been established in the kroon and in Estonia's financial system, the Bank of Estonia will eliminate all restrictions on payments, for both current and capital transactions for convertible and nonconvertible currencies, along with the 100 percent repatriation and conversion requirement, by the end of the year. The possibility of accepting the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement will be considered in due course. Furthermore, the authorities are very much aware of the dangers of protectionism, and they remain fully committed to the continuation of their open economic policy, which will be the main route to higher living standards. In that light, the authorities will keep the possibility of eliminating the recently introduced tariffs on grain and flour from Russia under regular review. However, in its trade with industrial countries, Estonia continues to face import restrictions, especially on textiles and agricultural products. The Estonian authorities hope to finalize a free trade agreement with the European Community (EC) in the near future without any such restrictions.

Recently, much attention has been paid to Estonia's progress in reorienting its trade toward the West. However, it should be emphasized that Estonia also stands ready to revitalize the trade links with the eastern countries as soon as conditions permit.

The current account for the program year of 1992/93, excluding official transfers, was broadly balanced, in contrast to the projected deficit of $213 million. Furthermore, the gross international reserves of the Bank of Estonia now represent almost 4.5 months of imports, and this positive trend is continuing. This past summer, Estonia witnessed an unprecedented tourism boom, which is further strengthening the balance of payments outlook for 1993. However, the authorities acknowledge that Estonia will need substantial inflows of foreign financing for imports, especially of investment goods, which are required to support the projected economic growth. The projected deficits are expected to be covered by official balance of payments support--including the purchases from the Fund under the STF--and by private capital inflows. The Government will direct the EFB to place the official funding with the Estonian Investment Bank or with eligible commercial banks. These banks would use these deposits to finance medium- and long-term lending to enterprises for investment purposes.

The authorities recognize that one of the keys to early and sustained economic growth is the rapid resolution of both the privatization and restitution issues. This process has taken longer than originally anticipated, to a large extent owing to difficulties in resolving issues related to restitution, difficulties that have placed considerable constraints on the administrative capacity of Estonia. In addition, there is a definite problem with the legal framework for privatization. It is understood that clarifying the authority of various laws and government agencies will be vital in order to proceed with rapid privatization. Furthermore, the authorities are determined to improve the conditions and structures necessary for the development of businesses. This will also entail adoption of various legal acts, and provisions of guarantees to both domestic and foreign entrepreneurs.

The authorities intend to request support from the World Bank and the EBRD, including technical assistance, in implementing the privatization measures. With the adoption of the April 1993 deadline for filing claims, the focus of the restitution effort will now turn to the rapid processing and resolution of these claims. The Government also intends to decentralize the process of privatization, so that the sale of state property can be effected by the public sale of shares by institutions other than the Privatization Agency. At the same time, the Government is going ahead with privatization, using vouchers mainly for housing and the privatization of large-scale enterprises.

I would like to conclude with another quote from the above-mentioned speech by Prime Minister Laar: "Estonia's success confirms that only an extremely conservative financial policy and a very liberal economic policy can create the dynamics for future growth and prosperity." The authorities remain committed to this approach.

Mr. Jonas made the following statement:

I congratulate the Estonian authorities on their achievements in transforming their economy. They have implemented a radical, consistent, and therefore successful reform program. Since questions are raised from time to time about the appropriateness of the Fund's traditional prescriptions of radical liberalization, restrictive fiscal and monetary policies, and vigorous structural reforms for the situation of the countries of the former Soviet Union, the case of Estonia provides an invaluable demonstration of their value, which should be taken to heart even by the largest of the countries of the former Soviet Union.

The Estonian authorities are now in a position to shift their attention from the implementation of radical reform to the consolidation of its beneficial effects. The increased flexibility of the labor market, a stronger banking sector, and the completion of privatization, should all bolster the supply response. Even though these measures are only in the early stages of implementation, GDP is expected to grow by 6 percent in 1994, which is an encouraging indication of the underlying strength of the Estonian economy.

In view of the persistence of output losses in the rest of Central and Eastern Europe, it is remarkable that Estonia's output decline is expected to bottom out this year and to increase by 6 percent next year. Since Estonia was among the countries hit hardest by terms of trade shocks and the disruption of trade with the countries of the former Soviet Union, such an output performance gives little support to the notion that trade shocks were a major factor in the output decline of the transition economies. Although the growth of Estonia's exports to the industrial countries has been large, it is no larger than the growth of exports of other reforming countries to the industrial world, and thus does not fully explain the differences in growth performance. Low unemployment sometimes reflects poor progress in restructuring, but resistance to the reallocation of productive assets can only delay, not prevent, the necessary decline in output. It cannot account for a dynamic growth of 6 percent. A partial explanation may be that the growth is starting from a very low base following the large cumulative decline of 1990-1992. I would be interested in the staff's explanation of Estonia's positive output performance and prospects.

Just as encouraging as Estonia's output performance is the rapid decline in inflation. It is crucial that inflation remain low in the future, in order to preserve competitiveness and confidence in the domestic currency, and to permit continuation of the rapid growth of exports to western markets. Generally speaking, Estonia's inflation differentials vis-à-vis its trading partners should not exceed its differentials in productivity growth. Productivity enhancing foreign direct investment has the potential to help protect Estonia's competitiveness.

Also crucial for achieving the inflation target is continued fiscal prudence. I am glad to see that the government budget for 1994 is presented as nearly balanced, without recourse to bank financing. The planned tax system overhaul should simplify the tax structure greatly and enhance its efficiency, and increase tax revenues in the medium and long terms. The staff believes that the impact of the tax reform on revenues might be slightly negative. It would be interesting to know its possible impact on the domestic price level.

Important challenges lie ahead for monetary policy. So far, the currency board has played a useful part in supporting price and exchange rate stability. The soundness and efficiency of the banking sector will have to be monitored to forestall potential banking crises if the authorities are to achieve their goal of preserving the currency board's integrity. A pillar of currency board integrity is the limit on its emergency lending to the commercial banks as the lender of last resort, and only a sound banking sector can prevent this from becoming an unbearable constraint.

Significant progress appears to have been made recently toward strengthening the financial position of commercial banks. Increased capital requirements, an effective bankruptcy law, and the closing of a major commercial bank have combined to signal to the remaining banks that hard-budget constraints are not just a figment of the theoretical literature, but problems still remain. For example, the staff reports that some commercial bank liquidity is deposited abroad because the banks are reluctant to lend to any but the most creditworthy borrowers. It is certainly undesirable to transfer any of Estonia's limited domestic savings abroad, instead of using them to finance domestic investments. Even though these outflows coincide with the liberalization of capital account transactions, it would be incorrect to try to prevent it by reversing the capital account liberalization. Experience has shown that the presence or absence of capital account controls is not a major factor in creating capital outflows.

From the economic standpoint, the only correct way of reducing outflows of domestic savings is to make assets denominated in the domestic currency more attractive, and since this requires establishing confidence in the domestic currency, there is no quick fix. Having already made considerable progress in this direction, Estonia will find that the attractiveness of its domestic assets depends most importantly on the attractiveness of domestic investment opportunities, and thus ultimately on the efficiency of its business sector. This interdependence between the attractiveness of domestic assets and business sector performance mirrors the close interdependence between monetary policy goals and progress in privatization and restructuring of the enterprise sector.

It will not be possible to restore and preserve the financial strength of the enterprise sector without a certain level of investment. At present, new lending to newly established private enterprises is obstructed by high transaction costs and poor information about potential borrowers, and also by high real interest rates. With nominal lending rates now running between 25 and 30 percent, and with inflation, as measured by the consumer price index, between mid-1993 and mid-1994 expected to reach about 15 percent, would-be borrowers face real interest rates of 10 to 15 percent, assuming that their expectations of future inflation coincide with official inflation projections. Using the more relevant producer price index measurement of inflation--which is usually lower than the consumer price index measurement--indicates even higher real rates. This calls for gradually narrowing the spread between lending and borrowing rates, while simultaneously strengthening the financial position and reserves of commercial banks.

In the external sector, the great progress Estonia has made with trade liberalization is remarkable. An exception is the recently imposed import tariffs on certain subsidized agricultural products from Russia, and the staff has urged the authorities to grant no further protection to domestic producers. I should say, however, that import tariffs that only offset the subsidy element, and which only increase the prices of imported goods until they reflect the true production costs, do not represent an inappropriate or undesirable protection of domestic producers. It is rather to the countries that are exporting subsidized commodities that the policy changes should be recommended, namely, Russia and the countries of Western Europe. It is a sad truth that, in discussing the transforming countries, staff papers now regularly feature references to the export obstacles imposed by many industrial countries. The only comfort to the transforming economies is the reflection that, by opening their economies to external competition unilaterally, their western partners are leaving them to enjoy--unilaterally--the benefits of these policies.

Regarding wage policy, Estonia, like other countries of Central and Eastern Europe, implemented a tax-based incomes policy as an important ingredient of its stabilization efforts during the initial phase of the transformation. Now that these efforts have succeeded, the authorities have decided to forsake wage policies and rely more on the existence of budget constraints on both private and nonprivate enterprises. This is certainly a courageous step, reflecting the authorities' confidence that inflationary pressures are now under control. It also underlines once more the great urgency of rapid progress in privatization, because only in a strong private sector will enterprises operate in response to market logic instead of looking to state interventions.

The strengths of the program before us, and the Estonian authorities' solid record of policy implementation, fully justify the approval of this stand-by arrangement and of the drawing under the systemic transformation facility.

Mr. Dorrington made the following statement:

The Estonian authorities deserve strong commendation for the substantial progress they have made in lowering monthly inflation and in maintaining a tight fiscal stance by reducing tax arrears, widening the tax base, and enforcing strict spending controls. In addition, major strides continue to be taken in implementing structural reforms. I endorse the staff appraisal, and will limit my comments to a few key policy issues and relations with the Fund.

A tight fiscal policy is a necessary discipline, in particular given the currency board system that has served Estonia well. Continued perseverance with the existing tight policy overall is needed to consolidate progress toward the objective of low single-digit annual inflation next year. Fiscal pressures are only likely to intensify given the outlook for unemployment and the urgent need for investment spending. Within the overall budget position, however, it is important that a balance be achieved between expenditure control and the desire to keep tax rates as low as possible, and the need for vital infrastructure investment and other priority expenditure. Estonia should not rule out completely the possibility of higher tax rates than those currently envisaged, although achieving higher revenue through further base broadening and effective implementation would obviously be preferable.

It is a joy to read of a tax system that is virtually free of exemptions and with fringe benefits subject to tax. I hope that it survives all the pressures from interest groups and vested interests that are bound to emerge. It is certainly easier to resist the introduction of distortions than to remove them later, as I am sure most of us can testify.

Another type of distortion is minimum wages, and I welcome the plan to increase flexibility in the labor market through the removal of the minimum wage, in conjunction with more targeted social safety net assistance. The authorities' focus on active labor market policies, especially in the areas of training and labor mobility, is also welcome. Despite an increase in unemployment to 4 percent, the still artificially low level of unemployment suggests a continuing reluctance by enterprises to lay off employees.

It will be important to monitor wage-push pressures following the replacement of the formal incomes policy by the use of the Government's inflation target as the basis for wage settlements, especially given the extent of the real wage decline since 1991. The credibility of a forward-looking government inflation target will only be maintained if actual inflation is close to the target. It is vital, therefore, that the target be both ambitious and credible. Failure to meet it would quickly erode the credibility of such a system. I am not advocating looser targets, but rather, a stronger resolve to achieve them.

Earlier, inflation appeared stuck at 2-3 percent a month, and the program now assumes that monthly inflation will continue at a rate of 1-1.5 percent a month for several months. The most recent figures make it difficult to determine the current underlying rate. I would appreciate any further comments the staff can make about what the current underlying rate is; on why inflation appears to be so stubborn following the past achievements, and given the tight policy stance of the currency board; on the margins for error in the inflation forecast; and on any contingency plan in the event that progress is not as rapid as hoped.

The sustainability of the currency board arrangement requires that low inflation to maintain international competitiveness be brought about by the price and wage flexibility needed to react to both external and domestic shocks. The fact that there is a large margin between interest rates in Germany and Estonia demonstrates that there remains some way to go in establishing full credibility.

Confidence in the financial system has been successfully restored, but the banking sector still faces significant structural impediments to the resumption of lending needed to assist the recovery. The recently passed real estate law, allowing land and fixed assets to be used as collateral, is a helpful step in this regard, and I certainly welcome plans to introduce more effective supervisory sanctions as an integral part of strengthening confidence in the banking sector. However, stronger banking supervision--which is by its nature likely to restrict lending--needs to be complemented by strengthening the financial sector's ability to assess lending opportunities. I was therefore pleased to see that technical assistance support to enhance credit evaluation was also part of assistance by international financial institutions to the banking sector. It is to be hoped that the increase in bank lending to the private sector in the third quarter is a reflection of the success of that strategy.

I welcome the Government's plans to provide legal resources to local authorities to speed the resolution of restitution claims. It is to be hoped that this will act as a catalyst to privatization.

I also welcome the implementation of an appropriate structural and legal framework to back industrial restructuring, and the planned introduction of a competition law. The bankruptcy law that was passed over a year ago appears to have been particularly effective in Estonia, in contrast to many other countries, in hardening budget constraints and decreasing tax arrears. I would appreciate staff comments as to why that might be the case, and the lessons that might be drawn from it.

Regarding Estonia's relations with the Fund, I could not help noticing that, despite many other similarities with the papers for Lithuania last week, today's staff papers make no mention of the authorities' desire for a follow-on arrangement under the EFF. I can understand the authorities' desire to graduate quickly from the use of Fund resources, and I do not want to underestimate either the authorities' good performance to date, or what I expect from this program--which, of course, I approve without reservation. Neither am I suggesting that, in the absence of such a program, the authorities would not follow appropriate policies. However, it would be a mistake if Estonia were not to take advantage of a further arrangement with the Fund. Perhaps one of the most important things that a follow-on program could do would be to enhance international private sector confidence and help promote needed capital inflows. To the extent that private capital inflows exceed the expectations in the paper--and they might by a large margin--Estonia would be free not to draw. Indeed, it is not implausible that Estonia might not have to draw all the tranches of this arrangement. I would be interested to hear comments from the staff and Mr. Bergo on that point.

Mr. Schoenberg made the following statement:

We welcome the program and we therefore support the proposed decisions on a second stand-by arrangement and a purchase under the STF. I associate myself with the remarks of Mr. Dorrington on the benefits of a Fund-supported program to follow the present stand-by arrangement. I agree with the general orientation of the program.

Undoubtedly, Estonia has joined the leading group of countries that are transforming themselves successfully. I agree with Mr. Jonas that the case of Estonia provides a striking demonstration of the general appropriateness of the direction of Fund advice. The first program was implemented successfully, and almost all performance criteria were met. Estonia was quick to reform its currency, to liberalize prices, to tighten fiscal policy, and to begin the task of restructuring the tax system. The main--and outstanding--result was a significant reduction in the rate of inflation. The initial and inevitable decline in GDP owing to the terms of trade shock and the disruptions in trading arrangements was halted remarkably quickly, and production appears to have recovered. In fact, a good deal of new private sector activity--which already accounts for about 40 percent of the economy--may escape statistical recording.

With the proposed new program, Estonia remains committed to building a market-based economy, consolidating the progress already made, and laying the foundation for sustained growth in the period ahead. However, the staff rightly points out that much work remains to be done, especially on the structural side of the economy, while maintaining macroeconomic stability. Hence, we welcome the Government's intention to address the urgent need to improve infrastructure by formulating a public investment program for 1994. In the face of the limited scope for discretionary monetary policy, it is also appropriate to aim at a practically balanced budget, except for what can be financed through external borrowing from public lenders for investment purposes.

With respect to monetary policy, the staff paper unfortunately does not contain any detailed assessment of the currency board system, or of the appropriateness of the exchange rate. The currency board system has served Estonia well so far, although I share Mr. Dorrington's concerns about the inflation outlook. The system, together with the fixed exchange rate, contributed strongly to enhancing confidence in economic policies, and enabled Estonia to import stability from abroad. However, the question arises as to when, during an increasingly successful process of stabilization, the currency board could become--with all of its stringencies--an impediment to a strongly growing economy. Perhaps the staff could comment on that issue.

Since the importance of a sound and solid banking system cannot be overstated, one of the program's objectives is improving the performance and stability of the banking sector so that it can better act as a financial intermediary. We are pleased to note that the banking crisis that dominated monetary developments during the first program seems to be over, owing to successful restructuring efforts by the Bank of Estonia. Confidence seems to have been gradually restored. Nevertheless, the evolution of a market-oriented banking system in Estonia is still at an early stage. Therefore, we welcome the measures to be implemented by the authorities, such as the enhancement of supervision capabilities, implementation of a standardized accounting plan, the intention to develop a plan for implementing international capital adequacy standards, and the privatization plans. All these measures should lead to an improvement in the capabilities of commercial banks.

I learned from recent articles in the press that the Bank of Estonia has decided not to extend new commercial licenses this year. Perhaps the staff could tell us more about the Bank's strategy during the course of the program period in this regard.

Regarding structural reforms, we welcome the intended acceleration of the privatization and restitution processes. Since privatization is one of the cornerstones of the program, the authorities should not hesitate to use a variety of measures to promote the sale of enterprises. On page 13 of the staff paper, I note that by the end of 1993 or early 1994, 100 large enterprises will be privatized, and the proceeds will be used to finance funds devoted to compensating restitution claims and other expenses. In this context, we support the intention of the authorities to consider the possibility of vouchers being made tradable. The experience in Germany supports the view that without a speedy settlement of the restitution problem, it will be difficult to mobilize sizable long-term investment in either agriculture or industry. The provision of legal and administrative services in this area to local authorities might be helpful.

With respect to trade issues, the staff points out that both current account and trade balances were stronger during the past program year than originally envisaged. The drop in energy imports from Russia seems to indicate that the use of energy responds to market signals. In this respect, the substitution elasticity might be even greater in Estonia than in other countries in transition. The rapid reorientation of Estonia's exports toward the industrial countries--most impressive in itself--offsets to a large degree the contractionary impact of the disruption of trade with the states of the former Soviet Union.

On the occasion of the Board's discussion on Estonia in January 1993, the staff pointed out that it was difficult to identify precise reasons for the successful reorientation of Estonian foreign trade. Factors mentioned were the confidence in the currency and the fairly competitive exchange rate at the start. Perhaps it is now possible to draw a more comprehensive lesson from the Estonian experience. In particular, it might be useful for other countries in transition to get evidence about the importance of factors such as the volume of direct investment, the pace and level of privatization, and the role of joint ventures.

The strong export performance of the Estonian economy is certainly a surprise given the real appreciation of the kroon during the first program year and the recession prevailing in major trading partners. One explanation may be the original undervaluation of the kroon, which was, however, probably corrected in the course of this year. Export sector competitiveness may be preserved in the future provided that Estonia's inflation differentials vis-à-vis its major trading partners are matched by corresponding differentials in productivity growth, as Mr. Jonas observed. That this might not be altogether implausible in a quickly transforming economy such as that of Estonia is supported by the fact that capital inflows from abroad--used overwhelmingly for project financing--are projected to increase strongly in the near future; indeed, they are expected to double from 1992 to 1994. Furthermore, on page 15 of the staff paper, the staff notes that private capital inflows may turn out to be substantially larger than envisaged. Such strong capital inflows may exercise beneficial effects on productivity and growth, but may also push up domestic money supply and the inflation rate. I would be interested to learn, therefore, whether the staff has made any projections about the future path of the real exchange rate of the kroon. In particular, I wonder whether or not a further real appreciation of the kroon owing to capital inflows is likely, and if so, what the consequences would be for the competitiveness of the export sector.

Mr. Lvin made the following statement:

This chair had an opportunity to express its admiration and support for Estonia's approach to economic adjustment during the discussion last April of the 1993 Article IV consultation with Estonia. Since then, the process of economic transformation has proved to be solid and stable enough to ensure the full observation of all performance criteria under the stand-by arrangement.

We are delighted to note that some prospects about which we were concerned in April did not materialize. For example, the unemployment rate has remained low, and thus has not excessively pressured the budget. The curb on wage increases has turned out to be sufficient to ensure stability both in domestic prices and in foreign competitiveness.

These and other successes, which are convincingly highlighted in the staff paper and the statements of Mr. Bergo and the staff representative, have been achieved through the authorities' implementation of bold, sound, and transparent economic policies. Such soundness was provided, inter alia, by the fast and irrevocable introduction of a national currency and by the adoption of a very strong and rigid currency board arrangement. The case of Estonia should be an instructive lesson for other countries of the former Soviet Union when they are considering options for their currency arrangements. The Fund provided comprehensive and timely financial and technical support for this policy during the critical period of its implementation--well before any other substantial official disbursements became available. This assistance was by no means wasted. That is why it should be expected that the financial resources available under the newly requested arrangements will be utilized for strengthening the adjustment process.

The justification for this confidence can be seen in the roughly balanced state budget, and the prudent Government regulation of investment activity through the Public Investment Program and the External Financing Board. We are most impressed by the authorities' commitment to use a significant part of Group of Twenty-Four donor country financial resources, and the entire counterpart of purchases under the STF, for strengthening the long-term lending capability of the Estonian banking system, rather than for direct disbursements through Government agencies.

This commitment may be regarded as a natural consequence of the authorities' attitude toward the banking system and financial regulation. The quick and definite response to the banking crisis that occurred in the fall of 1992 has made domestic banks cautious. It might be supposed that the authorities were fully aware of the recent banking troubles of their Scandinavian neighbors. Since the Bank of Estonia is not the lender of last resort, prudent banking supervision will shortly be developed further in conformity with the most reliable standards of the Bank for International Settlements (BIS). With these measures, accompanied by the real implementation of legal instruments, such as bankruptcy and real estate laws, the Fund's financial assistance will facilitate the final transition to a sound financial system.

Having established rigid performance criteria in the arrangement under discussion, there is every reason to anticipate that the Fund's resources will be used for market-oriented purposes. However, the question could be asked whether it was necessary to maintain strong restrictions on capital account operations, as well as on currency repatriation and conversion requirements, since the full backing of base money was established. However, the authorities' intention to abolish all these restrictions no later than December 31, 1993, may increase significantly the opportunities for foreign investment in Estonia, thus diminishing the country's dependence on official borrowing.

The program presented in the memorandum that accompanies the authorities' request is probably the most liberal and market-oriented of any of the programs adopted by the countries in transition. The cautious and detailed approach toward accelerating the privatization process deserves special mention. In this area, it seems that the authorities have taken carefully into account the experiences of the other countries in transition. The channeling of privatization proceeds to the special fund--as recommended by this chair--rather than to regular budget revenues, will underline the fact that improving the property ownership structure--not the fiscal position--is the main purpose of privatization. The authorities intend to make full use of the comparatively small Estonian economy, and to provide the public with detailed information about the properties earmarked for privatization. At the same time, the strict and transparent separation of a voucher-oriented stake from a cash-oriented one is undoubtedly a wise solution. In this regard, this chair wonders who will be eligible to participate in the voucher program. We urge the authorities to avoid any discrimination in this area, as this would have a serious impact on the public's respect for the newly gained property rights. A comment by the staff would be welcome.

We commend the authorities' intention to liberalize the labor market. The refusal to maintain a minimum wage mechanism in order to combat unemployment is a very courageous step that is often suggested by economists, but is rarely taken by politicians. There are also theoretical solutions in other areas that politicians regard as too radical. The Estonian authorities, who have embarked on perhaps the toughest reform path, may have benefited from considering these solutions. I wonder whether other more sophisticated reform measures aimed at reducing the state's involvement in the economy, such as in the areas of education, health, and pensions, are envisaged or are being discussed, in addition to those to be set in place during the 17-month period covered by the stand-by arrangement.

In April, this chair expressed anxiety about the introduction of discriminatory tariffs on Russian agricultural imports that appeared to be inconsistent with the liberal orientation of Estonia's trade policy, and which heavily burdened Estonia's consumers. We encourage the authorities to take steps to eliminate them as soon as possible. We are sure that this move would strengthen Estonia's position in its push to eliminate restrictions on its own exports.

We fully support the proposed decisions.

Mr. Oya made the following statement:

I welcome the successful completion, with an excellent economic performance, of the preceding program supported by a stand-by arrangement. I also commend the staff for having given the authorities good advice. Over the past year, the authorities have implemented all the economic reform measures and have produced good results in many areas. Output has recovered, inflation has been contained, and the privatization of enterprises is making progress. The Fund's prescriptions work very well in most cases, but Estonia is the rare case in which every single

Fund prescription has worked, thanks to the determination and consistency of the authorities' efforts.

Regarding the reform process in the period ahead, the authorities are now beginning to enter the second phase of economic reform, following the successful completion of the first phase. In the second phase, they will have to maintain the macroeconomic stability that has already been achieved, and put Estonia's economic growth on a sustainable path. The authorities should keep in mind that this task is not an easy one and will require them to make great additional efforts.

I agree with Mr. Bergo that banking sector stabilization should be given high priority. Banking crises have a widespread and lasting effect on an economy, and therefore could be extremely dangerous to an economy if the authorities do not respond to it appropriately. In this respect, I was impressed by the measures taken by the authorities to overcome the banking crisis in the fall of 1992, including the Bank of Estonia's courageous decision to merge two of the three major commercial banks and to put the third into liquidation. A continued effort to restore confidence in the banking sector will be the key to the success of the transformation of the Estonian economy, especially in terms of attracting foreign private investment.

I support the major overhaul of the tax system through the elimination of all exemptions from the value-added tax and the unification of the income tax rate at 25 percent. These measures are in line with the recent tendency of tax reform in industrial countries, and will increase the sense of fairness among taxpayers, as well as reduce much of the burden on the Government.

I would emphasize the importance of maintaining a prudent financial policy. It is true that the authorities have been surprisingly successful in containing inflation, and I agree that it is now imperative to focus on increasing investment for infrastructure. However, as the staff rightly points out, the main challenge for policymakers will be to consolidate the gains already made, especially concerning maintaining fiscal prudence and the integrity of the currency board. Confidence in price stability is very fragile and, if lost, hard to restore. While the increase in consumer price inflation to 3 percent in September reflected in part a temporary increase in import prices, it will nevertheless be necessary to remain vigilant against a resurgence of inflation. It is encouraging, therefore, that the authorities expressed their firm commitment to persevere with a prudent financial policy in the memorandum of economic policies.

Substantial progress was made on structural policy during the preceding program period. It only remains for me to encourage the authorities to resist political pressures and accelerate the reform measures for the transition to a market economy.

Estonia was the first of the states of the former Soviet Union to reach an agreement on a stand-by arrangement with the Fund. It was also the first state of the former Soviet Union to introduce a national currency, and thus provides many important lessons for other such states. The decisions the authorities have made have been appropriate for the economic circumstances. For example, the decision to make kroon bank notes and reserve deposits fully backed by, and convertible into, deutsche marks at a fixed rate of exchange contributed a great deal to the stabilization of the exchange rate. I hope that the Fund will continue to assist Estonia by providing technical assistance, so as to enable it to accelerate the reform process.

I support the proposed decisions.

Mr. Desruelle made the following statement:

Like previous speakers, I commend the authorities for the positive results they have achieved so far in their stabilization policies. Estonia's success in bringing inflation down sharply and stabilizing output in a very short period is testimony to the effectiveness of the chosen reform strategy and to the commitment of the authorities to implement this strategy fully.

The central element of the authorities' stabilization policy is the strong nominal anchor provided by the peg of the kroon to the deutsche mark and the currency board mechanism, supported by appropriate internal policies--namely, a prudent fiscal stance and a firm incomes policy.

It is noteworthy that this nominal anchor policy has not damaged Estonia's competitiveness, a fact made evident by the strong growth of exports during the last year. This strong growth was in spite of the fact that the combination of an inflation rate much higher than that of Germany, and of an appreciation of the deutsche mark vis-à-vis the currencies of some of Estonia's major trading partners, has led to a substantial new appreciation of the exchange rate.

Two factors can explain this apparent paradox. The first factor is the nominal rate at which the kroon was pegged, which I understand was chosen in a straightforward way, without any deliberate attempt at undervaluation. This turned out to leave some room for real appreciation. The second factor is that, by creating an environment favorable to investment, the nominal anchor policy made possible relatively large flows of foreign direct investment, which, in turn, boosted the economy's competitiveness. There is a lesson of great relevance in this experience.

I fully agree with the authorities' statement that "it is crucial to continue to implement a strong and consistent stabilization and reform program so as to consolidate the gains already made and to lay the groundwork for sustained growth in the period ahead." I also agree with the thrust of the program presented in the memorandum of economic policies. I therefore fully support the proposed decisions.

Regarding monetary policy, maintaining the integrity of the currency board is undoubtedly the right priority at present. This arrangement has served Estonia well. In the future, at such time as the credibility of the currency becomes more firmly established and the growth of output is such as to cause the currency board mechanism to produce an unwanted deflationary bias, it will be time to modify this arrangement. It is thus essential to keep bringing inflation down so as to limit, and then stop, the real appreciation of the currency.

The prudent fiscal stance that the authorities have adopted and expect to continue is commendable. However, some fragility in the fiscal situation can be noted. The stronger than expected fiscal performance during the first stand-by arrangement was due in part to lower unemployment benefits on account of a slow rise in official unemployment and to a low level of capital expenditures. It might be wondered whether expenditures on both items will not have to be significantly higher in the coming year, especially for capital expenditures. I realize that some increase in capital expenditures is already provided for in the program at present.

In these circumstances, the negative impact of the tax system reform--the value-added tax and income tax laws--on revenue is mildly worrying. This is not to deny the significant advantages that are to be reaped from simplifying and broadening the base of the value-added tax and the income tax, both in terms of efficiency and enforcement. Nevertheless, it might have been preferable, at this still relatively early stage of the stabilization and restructuring process, to aim for at least a revenue-neutral reform. I would like to hear the opinion of the staff on this matter.

On the positive side, the authorities' intention to rationalize the social safety net so as to better target assistance to the neediest groups and to adapt the pension system to the new economic environment is welcome.

I note the authorities' decision to abrogate the formal incomes policy, and instead to announce six-month inflation targets to serve as a basis for wage settlements. The formal incomes policy had worked well, and had been an essential complement to the nominal anchor policy. I understand that the constraints on the budgets of firms caused by the tightness of the credit market and the threat of bankruptcy are believed to be sufficient to tie closely together increases in wages and in productivity. Nevertheless, in light of the fairly high rate of increase in wages in September, and the need to lower inflation to the level of Estonia's western trading partners, I wonder whether this policy shift is premature. I would welcome comments from the staff on this matter. In any case, it will be essential to monitor wage developments closely to ensure that undue wage increases do not adversely affect the economy's competitiveness.

I will now address the measures and actions designed to boost the economy's supply potential. I encourage the authorities to implement fully the privatization and restitution measures contained in the program, so as to ensure a rapid and unambiguous transfer of property into private hands. With regard to the banking sector, the strategic importance of well-functioning, sound, and deep financial markets for growth is well understood by now. This is particularly obvious in the case of Estonia, given the role that the financial sector will be called to play in the intermediation of foreign funds for investment purposes.

The Estonian financial sector went through a major crisis last year. As a result of swift action by the authorities, damage to the financial system was controlled. The authorities state that "confidence in the banking system has largely been restored." This is welcome, as is the lesson about the value of prudence learned by the banks during this episode.

However, the present state of lending operations by banks--in particular, the extremely strict conditions put on any lending, and the absence of long-term lending--indicates that the banking system has some way to go before it can adequately fulfill its intermediation role. The authorities are therefore strongly encouraged to pursue vigorously their efforts to develop commercial banking. In addition to the measures included in the program, I wonder whether the Estonian banking system could not be strengthened by the increased participation of foreign institutions, which would bring with them useful technical expertise.

It is obvious that increases in both private and public investment will be needed to generate the desired output response. This need is reflected in many measures of the program, including the increase in budgeted capital expenditure and the actions envisaged to ensure the efficient disbursement of foreign funds.

Nevertheless, I note that the absolute level of capital expenditure by the General Government is forecast to be slightly less than 3 percent of GDP. This figure may appear low compared with the level of public investment undertaken by many fast-growing economies, where levels of 10 percent of GDP are not uncommon. I would therefore like to hear the opinion of the staff as to whether additional efforts on public investment might be needed. In particular, are there any preliminary indications of this coming from the work being done in collaboration with the World Bank on the Public Investment Project?

Regarding the financing of investment, I note that household savings, and--more generally--domestic savings are expected to remain low, and that a significant part of total investments will be financed by foreign savings in consequence. I would welcome comments from the staff on the reasons for this low level of savings, beyond the impact of lower revenue owing to falling output. In particular, has the banking crisis of 1992 adversely affected savings mobilization?

I welcome the precautions taken or envisaged to ensure the efficient disbursement of foreign funds, such as the establishment of the External Financing Board. The important role to be played by banks in the disbursement of foreign funds provides a strong incentive to make every effort to improve quickly the long-term lending capabilities of the banking sector.

Miss Vori made the following statement:

Estonia is already well advanced in the process of transition to a market economy. With the successful completion of the previous stand-by arrangement, significant results have been accomplished in the stabilization of the economy, the liberalization of prices and the exchange rate, the introduction of a new currency, and the adoption of legislative initiatives in the context of structural and institutional reforms. In order to sustain the momentum of the reform efforts, the authorities have formulated an economic and financial program for the period up to December 1994, to be supported by a new stand-by arrangement and a purchase under the STF. I am in favor of the proposed arrangement. I will review the economic strategy of the Estonian authorities.

In order to preserve the integrity of the currency board arrangement, which was chosen to foster disinflation in the economy, it will be necessary, first and foremost, to maintain strict fiscal discipline. I welcome the clarification in the fiscal accounts that has been obtained by listing separately as performance criteria the two different variables, the general government financial deficit and government net lending. This will help distinguish between the former, which should be broadly balanced to avoid inflationary bank financing, and the latter, which will be used to limit government lending operations to what can be funded from external borrowing. The revenue performance has been satisfactory so far, in particular when compared with that of other countries at a similar stage of the transition process. The planned reform of the tax system, however, is expected to result initially in a slight decline in tax revenues. In order to maintain the budgetary target of overall financial balance, the Government needs to identify areas in which contingency measures could be implemented to make up for eventually lower revenues, envisaging new taxes or cuts in budgetary expenditures. In particular, expenditures on current transfers and subsidies appear to be high; these should be evaluated carefully, so that inefficient and distorting Government contributions could be phased out.

Inflation in Estonia has been reduced sharply from a very high initial level to a low of 9 percent, on an annualized basis, in August 1993. However, the latest figure, which sets the monthly increase in the consumer price index for September 1993 at 3 percent, is rather worrying. While it may be accounted for by contingent factors, I would like to ask the staff whether it will induce the Government to revise its target for inflation for the semester ending in March 1994, now set at 7 percent. Also, how will the wage bargaining process be affected by recent developments on the inflation front? Finally, what margin is left for the real appreciation of the kroon--which is caused by a higher level of inflation in Estonia than in its trading partners--before Estonian competitiveness is seriously undermined?

Confidence in the currency board operation has remained strong, as proved by the continuing capital inflows and the decline of nominal interest rates reflecting declining inflation. The latest indications point also to a recovery of lending activity, which signals the successful reabsorption of the banking crisis of last year, and the improvement in domestic economic conditions. However, efforts are needed to strengthen the financial and banking system to make up for the lack of flexibility of the current monetary arrangement. In order to make the system work more smoothly, the authorities are encouraged to proceed with the implementation of planned measures aimed at improving the functioning of the interbank market, which will allow a more efficient use of the available liquidity. The still-large spread between deposit and loan rates indicates the need to increase competition in the commercial banking system by furthering banks' restructuring and privatization and strengthening prudential supervision.

Concerning some important structural issues, I welcome the authorities' efforts to clarify the legal and institutional framework of the privatization process. Issues related to property and ownership rights and restitution have all been settled, and the conditions are in place for fostering an acceleration of privatization. The liberalization of trade practices is at an advanced stage, and I urge the authorities to maintain their present liberal foreign trade stance, which has proven advantageous, as shown by the strong performance of Estonia's exports and their successful reorientation toward western markets.

Given the rigidity of macroeconomic policies that is implied by the currency board strategy, care will be required to foster greater price and wage flexibility. Price liberalization is close to being completed. Wage and labor market flexibility will also be enhanced. In particular, the Government is planning to eliminate the minimum wage; since pension benefits are linked to the minimum wage at present, this move will require a reform of the social security system as well.

Concerning wage determination, the authorities have shifted to a policy of decentralized wage bargaining, whereby wages in the state enterprise sector would be settled at the level of the individual enterprise, so as to take into account firm-specific productivity developments. The Government will not formally intervene in the wage bargaining process, but will announce semiannual inflation targets as guidelines for wage settlements. Comments from the staff on whether this would be sufficient to ensure that the wage awards of individual enterprises are compatible with the complex requirements of the general economic situation would be welcome. In particular, individual enterprises might overlook the risk that increases in their wages and prices would raise costs to all other enterprises and consumers, risking a higher level of unemployment.

I support the proposed decisions.

Mr. Abbott made the following statement:

Estonia continues to make significant strides forward in its transition. Stabilization efforts, in particular, have shown striking results in bringing down inflation to levels approaching single digits. As the initial price adjustments associated with price liberalization and the removal of various subsidies have worked through the system, the price stabilizing influence of the currency board has begun to be felt. The natural discipline imparted by the currency board on fiscal and wage decisions has seen a mutually reinforcing policy mix develop, as fiscal restraint and a tight incomes policy have reinforced the credibility of the currency board. Fiscal balance has relieved the financial system of potential financing pressures, and wage restraint has contributed to a competitive tradables sector despite the real appreciation of the kroon. Partly as a result, exports have shown great responsiveness in shifting to western markets. More broadly, the drop in production appears to have bottomed out earlier this year. The staff paper forecasts a significant upturn in growth, led by exports and investment. Given the low level of private domestic savings, as well as financial sector growing pains, foreign capital will need to play an important role in this process.

The Estonian economy appears poised for a recovery. Continued restructuring will take place and involve some hardships, but the overall picture appears promising. It is worth observing that the decline in output over the past few years was not matched by anything approaching a commensurate drop in recorded unemployment. This could suggest considerable labor hoarding and an implicit drop in enterprise productivity that might in turn hold in store the prospect of considerable labor shedding and enterprise downsizing or liquidations. As we understand it, however, such a scenario is unlikely. First, official figures underestimate actual unemployment. Output also appears to be underrecorded--in the private sector, in particular. Furthermore, the period during which such labor surpluses could have been sustained through interenterprise arrears and easy credit has largely passed. Much of the resulting labor market slack has begun to be absorbed by the recovery. If true, the current outlook would appear to be built on a more solid footing than official figures might suggest.

The surge in third quarter lending to the private sector is indicative of an upturn in economic activity. Moreover, the expansion in domestic credit would seem to suggest a less tentative posture by commercial banks, which have exhibited understandable caution following the banking crisis of last year. As the financial sector begins to respond to renewed borrower interest and new investment opportunities, the authorities appear to confront the challenge of balancing, on the one hand, a desire to see larger shares of funds--such as Group of Twenty-Four industrial country disbursements--channeled through the banking system, with, on the other hand, continued doubts about the ability of the system to absorb those flows effectively. I would appreciate staff views on how this process is likely to play out over the next year, as well as its views on where additional work is needed. It would be interesting to know more about how the EFB will reach its decision on whether or not the banking system can absorb these new deposits. Given the obvious preference to limit the Government's role in the actual intermediation of funds, the quicker the financial sector is modernized and strengthened, the better.

The authorities' approach to the growing pains of the banking sector appears sensible. On the one hand, they have made it clear that neither banks nor their depositors can expect government bailouts for unwise decisions. This policy has undoubtedly contributed to the gun-shy lending attitudes present earlier in the year, as well as the high spreads between loans and the cost of funds, but it has also established a prudent marker on the need for market-based discipline. While the Bank of Estonia maintains some excess reserves, from which it can provide limited emergency lending, the main message to market participants is one of self-reliance.

On the other hand, a number of measures have been instituted that should act to boost lending activity. The bankruptcy law was clearly designed with the creditor in mind, and with a clear goal of instilling greater borrower discipline. In addition, more recent passage of a real estate law, which permits use of property to collateralize loans, ought to provide additional security to lenders. Efforts to address other challenges, including increasing the ratio of capital to assets, developing an interbank market to boost liquidity, and enhancing accounting standards and information on borrowers, are also important to boosting the efficiency and strength of the financial sector. The staff's views on how the issuance of certificates of deposit by the Bank of Estonia so as to help foster greater interbank lending is evolving might be useful, since progress to date appears to have been modest. Action on all these fronts should create a lending environment conducive to a further narrowing of lending spreads, as well as longer and more varied terms. Again, however, we would appreciate staff views on how lingering weaknesses might best be remedied, and what is being done to this end.

Continued efforts to bolster the financial sector should complement the privatization process in general. Here, the Government appears to be taking action to remove some of the *impediments that have slowed the transfer of assets to private* hands, including efforts to resolve land restitution and property ownership issues, and decentralizing the process of selling state firms. Consistent with increased movement on privatization is the Government's sensible intention to replace the existing incomes policy with announcements of inflation targets, from which firms might base their wage settlements, together with reference to productivity developments. Continued freezing of public sector wages certainly sets an example of restraint, and should contribute to lower inflationary expectations.

Consistent with the objective of encouraging competition is the authorities' intention to break up certain monopolistic and oligopolistic arrangements in the oil shale and electricity industries. As presented in the memorandum of economic policies, such action ought to diminish sources of recent price pressures, in addition to bringing about efficiency gains.

The external sector will play a major role in Estonia's fortunes over the next year. Continued export growth and inflows of foreign investment should continue to benefit importantly from the stabilization successes registered by the authorities, in addition to the liberalization of the external trade and payments regime. Low enterprise profits and household savings point to the need for external capital flows to help fund needed investment. The external picture involving agriculture has some blemishes. Estonian agricultural products comprise some 25 percent of exports and face import barriers and subsidies in key European markets. This is a significant obstacle to an already difficult adjustment process. Moreover, one would expect the adverse effects to be felt in those areas that can least afford the resulting income losses. On the other side of the coin, Estonia is to be faulted for instituting tariffs on certain agricultural products itself. To the extent that such actions are a disproportionate reaction to subsidized imports and more a response to protectionist pressures, there is little rationale for their presence.

The Government's fiscal stance continues to be commendable. Moreover, the overhaul of the tax system appears to be developing quite favorably. In addition to the revision of the value-added tax, the changes in tax laws toward a uniformity of rates on individuals and businesses, respectively, are a positive development. Moreover, improved growth performance would appear to offer the prospect for revenue gains that might offset the slight decline in receipts that is expected owing to the tax changes. On the expenditure side, the transition process is expected to place continued demands on social safety nets. These demands, as well as infrastructure needs, will continue to pose choices regarding expenditure priorities. The authorities have demonstrated a clear intention to manage these priorities within the parameters of financial restraint, which we commend and encourage.

We can support the proposed decisions.

Mr. Shaalan made the following statement:

The period since Estonia launched its stabilization and reform program to transform itself from a command to a market economy has been a difficult one. I commend the authorities for persevering with these reforms and successfully implementing the first stand-by arrangement. This perseverance seems to have paid off already, as evidenced by the recent reduction of the monthly rate of inflation--notwithstanding the unexpectedly high figure for September--the turnaround in output and incomes, and the confidence in the currency board and the kroon. These achievements, which have been made possible by tight demand policies coupled with structural reform, set the stage for a consolidation of the gains and lay the groundwork for sustained growth in the period ahead. I am in broad agreement with the thrust of the staff's appraisal.

The expected recovery in investment and GDP in 1994 is welcome after the sharp contraction experienced since 1991, which has caused hardship for several segments of the population. The importance of attaining tangible results, in the form of higher output and income, so as to retain widespread support for the authorities' adjustment program, cannot be stressed enough. In their memorandum of economic policies, the authorities state that the main uncertainties associated with the current program relate to the ability of Estonia to sustain the export and investment growth required to generate the targeted increase in real GDP. Obviously, this will require the continued pursuit of appropriate policies to contain inflation and protect external competitiveness. However, it would also require access to the markets of trading partners. In this regard, it is disappointing that Estonia continues to face import restrictions and export subsidies from industrial countries. Perhaps the staff can inform us about the seriousness of these restrictions, and whether they hamper trade and output in a material way.

Fiscal policy will remain the cornerstone of the authorities' adjustment efforts, in particular since the central bank's power to create domestic credit is restricted through a currency board arrangement. The fiscal stance envisaged during the coming program period is broadly appropriate, and I welcome the measures envisaged to improve tax efficiency. Regarding the increased investment in infrastructure, which is expected to be financed mainly from abroad, I am inclined to agree with Mr. Bergo that the External Financing Board should contribute to more timely monitoring and channeling of external loans. Nevertheless, contingency measures should be adopted in case of unexpected developments or undue delay in disbursement of external resources, in order to stay within the fiscal targets.

The replacement of the present incomes policy with a free wage bargaining system at the enterprise level is indeed courageous, and as noted in Mr. Jonas's statement, reflects the authorities' confidence that inflationary pressures are under control. However, in view of the drastic erosion of real wages over the past few years, the recent increase in inflation, and the susceptibility of the economy to exogenous factors, it will still be necessary to remain constantly vigilant against inflationary pressures once the wage policy is made more flexible. The importance of adhering to a hard-budget constraint for the state enterprise sector thus becomes all the more necessary.

The staff notes that the official unemployment figure of only 4 percent in mid-1993 underestimates the actual level of joblessness. However, notwithstanding the likely increase in the number of enterprises expected to go into bankruptcy in the near future, the staff projects only a marginal increase in unemployment in 1994. This seems rather optimistic. Could the staff explain the basis for its unemployment projections?

The staff will recall from the Board's discussion on Lithuania on October 22, 1993, that Directors stressed the importance of a viable and healthy banking sector to safeguard deposits and channel funds for investments, which are a prerequisite for economic growth. The authorities' prompt and decisive steps in dealing with the banking crisis of autumn 1992, by recapitalizing and merging two ailing banks while liquidating a third, are commendable. Perhaps the staff can inform us as to whether the banking crisis is now over. Here, I have in mind recent reports that at least two additional banks--the Narva Bank and the Revalia Bank--have been declared bankrupt this year, and that a number of other banks have announced large operating losses. Perhaps the staff could comment on these developments.

I support the proposed decisions.

The staff representative from the European II Department stated that while the growth performance of Estonia had been good and growth prospects were promising, that needed to be viewed against the background of the sharp declines in output that had occurred in 1991 and 1992 as a result of the breakup of the former Soviet Union, the large terms of trade shock that had ensued, and the unavoidably rapid adjustment to that shock that had taken place. The recovery that the staff was projecting for 1994 would not do much more than restore output to its level at the beginning of 1993. Of course, the projections were based on official statistics, which might understate the actual output performance. Economic activity in Tallinn would appear to be visibly stronger than what was reflected in the official statistics, for example. The early confidence in the kroon and in overall economic policies that had been established was behind the relatively quick turnaround in economic growth. The authorities' policies had led to fairly quick success in reducing inflation, and a number of key structural reforms had been implemented at an early date, including that of an open trading system.

The changes in the tax system would lead to some revenue losses, on balance, the staff representative observed. Those losses would be offset by cuts in expenditure, so that the overall effect on the Government balance would be neutral. To guarantee that neutrality, the Government had submitted the tax changes to Parliament together with the budget; thus, passage of the tax side of the budget was contingent upon passage of the expenditure side. While the staff might have preferred a more clearly revenue-neutral tax reform, which would have made the task of expenditure management easier, the Prime Minister in particular had believed strongly in a proportional income tax at a lower rate of 25 percent. While the effect would be a revenue loss in the short term, which would have to be offset by expenditure reduction, it was to be hoped that the tax change would elicit a positive supply response over time. From the macroeconomic viewpoint, the tax changes were not expected to induce a general increase in prices.

A balanced budget and the streamlining and simplification of the tax system should have positive effects on the supply side in the medium and longer term, the staff representative reiterated. On the microeconomic level, the taxation of enterprises would not change much, but the base of the value-added tax would be broadened. While the base broadening would tend to increase tax revenues, some of the other reductions in taxation should have the opposite effect.

The current underlying rate of inflation was between 1 percent and 2 percent, the staff representative stated. Underlying inflation seemed to be stuck stubbornly around that level because the exchange rate still appeared to be undervalued. However, the staff expected the inflation rate to fall to the single-digit level, on an annual basis, around the middle of 1994. The margin of error was certainly less than 1 percent in either direction, but there might be months in which it might be somewhat higher. For example, the rate in October 1993 might be higher because of an increase in household heating costs that had taken place in that month. In that connection, the staff did not believe that the inflation target for the six months to March 1994 should be revised in light of the worse than expected inflation performance in September, which could be a temporary phenomenon. With respect to possible contingencies in the program in case of a higher rate of inflation, it needed to be borne in mind that the currency board arrangement did not allow for any such contingencies on the monetary policy side, but a strong incomes policy might be an appropriate response. For the time being, therefore, there were no such contingencies in the program. The authorities would be monitoring the inflation situation extremely closely in consequence.

Budget constraints on enterprises were proving effective in Estonia because the bankruptcy law had been implemented early, and some firms had already been forced into bankruptcy proceedings, the staff representative explained. One of the first bankruptcy actions had resulted from an enterprise with tax arrears that the tax administration had forced into bankruptcy, and from which it had subsequently collected the tax arrears owed. That action had sent a powerful signal that the Government would not contemplate bailing out bankrupt companies; it might serve as a useful precedent that other countries with economies in transition might want to emulate in dealing with the tax arrears problem.

The currency board arrangement had been analyzed in detail in the June 1993 issue of Staff Papers, the staff representative noted. The staff and the authorities believed that the exchange rate under that arrangement remained undervalued. The staff and the authorities also believed that the currency board arrangement remained appropriate for the time being and for the foreseeable future.

Large capital inflows might lead to some real appreciation of the exchange rate--operating through an increase in the consumer price index--only if the inflows were used largely to finance consumer goods, the staff representative pointed out. In the case of Estonia, however, capital inflows were likely to be channeled mostly into direct investments, which would improve labor productivity, in particular in the tradable goods sector. Therefore, the capital inflows need not cause the currency to appreciate. That assumption was part of the staff's exchange rate projection. In that connection, it might be noted that while the currency of Hong Kong was linked to the U.S. dollar through a currency board arrangement similar to that of Estonia, and while inflation in Hong Kong had been significantly higher than in the United States, inflation in Hong Kong had been concentrated in nontradables rather than tradables, leaving the currency arrangement and the exchange rate largely unaffected.

All residents, not just Estonian citizens, would be eligible to receive privatization vouchers, the staff representative explained. The number of vouchers awarded would be related to years of service.

The authorities believed that hard-budget constraints on enterprises had already acted, and would continue to act, to restrain wage growth, the staff representative commented, and in that sense, they did not believe that a move away from an incomes policy was premature. While the wage bargaining process might be affected somewhat by the higher inflation rate of September 1993, experience showed that there had in fact been little feedback of the inflation outturn on the wage bargaining process. The authorities and the staff would nevertheless monitor wage and inflation developments closely. Following the abolition of minimum wages, social benefits in the future would be linked to the poverty line. In that area, the authorities received technical assistance from the World Bank.

Public investment of 3 percent of GDP in Estonia was small in comparison with many other countries, the staff representative acknowledged, but it needed to be borne in mind that much of the infrastructure investment that was under the budget in many countries was outside the budget in Estonia, and was financed instead through the public enterprises. A World Bank mission, with Fund participation, was currently in Tallinn to review public expenditures in the medium term, and to attempt to set up a public investment program for the general government sector.

The authorities were making efforts to restructure the banking system, which had recovered almost fully from the banking crisis of the fall of 1992, the staff representative observed. The authorities intended to increase bank capital requirements in steps over the succeeding few years, with the aim of bringing them into line eventually with the BIS capital adequacy guidelines. A moratorium on the licensing of new banks was in effect until the end of 1993. Lingering difficulties in the banking sector included the immaturity of the interbank market, which was still in its infancy and functioning at a rudimentary level despite efforts to improve it. Some of the smaller banks were very weak and likely to disappear over time. A further improvement in banking supervision would be crucial, and Fund technical assistance was being extended for that purpose. Foreign financial institutions might also play an important role in fostering the establishment of a competitive banking sector and providing education and experience. In that connection, the banking system was completely open to foreign participation, but so far only two small banks had been established with foreign ownership.

The stronger banks in Estonia had shown an interest in playing a role in channeling foreign financial resources into the economy, the staff representative continued, even though they still needed to learn how to assess longer-term projects. It was difficult to judge the amount of resources that might be involved and the timing of the flow of funds. It was also still unclear what mechanisms the External Financing Board might use to determine how to channel the funds, and to which banks. One of the main conditions of eligibility for a bank to receive such flows would be its observance of the regulatory standards.

Of Estonia's exports, agricultural products were faced with the greatest difficulties in terms of restrictions on access to the markets of the country's trading partners, the staff representative pointed out. Trade in agricultural products had been excluded from all of the free trade agreements that Estonia had negotiated, including those with the Nordic countries. Another important Estonian export was textiles, which had been excluded from the agreements with the EC. However, the Nordic countries had included Estonian textiles--through an exemption--under their free trade agreements with Estonia.

The staff's unemployment forecasts had proved to be overly pessimistic in the past, the staff representative remarked. The staff believed that much of the labor shedding had already taken place, and that actual unemployment was significantly higher than what the official statistics suggested.

Concerning future Fund support for Estonia, the authorities were leaning in the direction of requesting another stand-by arrangement, although no firm decision had yet been taken, the staff representative concluded. It was less likely that a request for an extended arrangement would be forthcoming. The staff expected the authorities to draw under the

STF, and to purchase at least the initial tranche of the stand-by arrangement that they were requesting.

Mr. Schoenberg said that his comments were not meant to suggest that the currency board arrangement was not the appropriate regime for Estonia at present. However, he was concerned that such an arrangement provided virtually no room for maneuver of monetary policy. Monetary policy was further constrained by the fact that a fixed nominal exchange rate regime required a great deal of flexibility in the domestic economy, in particular with regard to real wages. If the real exchange rate were to appreciate substantially, then real wages would have to adjust accordingly, which could pose a problem for the authorities in the current circumstances of Estonia, especially taking into account the likely expectations of the population.

The staff representative from the European II Department, responding to a question from Mr. Dorrington, said that while the nature of a future Fund-supported program with Estonia was not yet decided, there was likely to be some type of continuing Fund support through one of the Fund's facilities.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/147 (10/22/93) and EBM/93/148 (10/27/93).

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 93/9 and 93/19 through 93/21 are approved.

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/93/184 (10/22/93) and EBAM/93/186 (10/25/93) is approved.

5. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/93/66 (10/26/93) is approved.

APPROVED: February 11, 1994

LEO VAN HOUTVEN
Secretary