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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/146

10:00 a.m., October 22, 1993

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	M. Sirat
	D. Desruelle, Temporary
J. Bergo	J. A. Solheim
	Å. Törnqvist, Temporary
J. de Groote	A. Cserés, Temporary
	T. Oya, Temporary
K. P. Geethakrishnan	
	K.-T. Hetrakul
	K. Link
	J. C. Estrella, Temporary
K. G. Kagalovsky	
G. Lanciotti	
	G. Torres
A. Mirakhor	
	B. S. Dlamini
	J. Dorrington
G. A. Posthumus	
	A. R. Ismael, Temporary
	W. Laux, Temporary
A. S. Shaalan	Y. Y. Mohammed
	N. Laframboise, Temporary
	J. M. Abbott, Temporary
	M. Ryan, Temporary
	A. M. Tetangco, Jr.
	Wei B.
	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

Also Present

IBRD: M. Farsad, Europe and Central Asia Regional Office; L. M. Hoppenbrouwer, Middle East and North Africa Regional Office; D. Pupkevicius, Assistant to Executive Director. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; A. Kammer, A. Knöbl, A. Lellep, G. Tersman, T. Wolf, B. Zavoico. External Relations Department: P.-M. Falcone. Legal Department: H. Cisse, R. B. Leckow. Middle Eastern Department: P. Chabrier, Director; S. H. Hitti, Deputy Director; M. El-Erian, S. N. Erbas, M. Fouad, Z. Iqbal, P. Kapetanovic, A. Mazarei. Policy Development and Review Department: T. Leddy, Deputy Director; J. Pujol. Secretary's Department: R. S. Franklin, A. Jbili, A. Mountford. Southeast Asia and Pacific Department: D. Buyantogtokh. Treasurer's Department: H. Flinch. Office of the Managing Director: G. R. Saunders, Personal Assistant. Advisors to Executive Directors: J. O. Aderibigbe, T. K. Gaspard, M. F. Melhem, R. Meron, R. Rainford, A. Raza. Assistants to Executive Directors: H. M. Al-Atrash, R. N. A. Ally, D. A. Barr, J. M. Burdiel, A. Cathcart, M. Dzervite, G. El-Masry, S. S. Farid, R. Ferrillo, H. Golriz, T. Isataev, T. Kanada, E. Kotova, S. C. McDougall, F. Moss, C. F. Pillath, E. Quattrociocche, A. Sighvatsson, L. Tase, V. Verjbitski, Wang Y., Wu H.

1. REPUBLIC OF LITHUANIA - STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on the Republic of Lithuania's request for a 17-month stand-by arrangement in an amount equivalent to SDR 25.875 million and on the Republic of Lithuania's request for an initial purchase under the systemic transformation facility (STF) in an amount equivalent to SDR 25.875 million (EBS/93/164, 10/7/93; Sup. 1, 10/20/93; and Sup. 2, 10/22/93).

Mr. P. Milasauskas, Deputy Governor of the Bank of Lithuania, was also present.

The staff representative from the European II Department said that the staff had been informed that, as of October 21, Governor Visokavicius had been relieved of his duties after a vote of no confidence in Parliament. A successor had not yet been appointed. However, in a speech before Parliament preceding the vote, the Prime Minister, Mr. Slezevicius, had reconfirmed that there would be no change in the direction of monetary policy following the personnel changes in the Bank of Lithuania.

Mr. Solheim remarked that, as the staff representative had noted, the Prime Minister had reaffirmed that the Government's commitment to the policies set out in the memorandum was unchanged.

Mr. Solheim then made the following statement:

> In April 1992, Lithuania was the first of the Baltic states and former republics of the Soviet Union to become a Fund member. Major changes have taken place in the Lithuanian economy and in its political situation since the Executive Board approved the stand-by arrangement with Lithuania in October 1992. Although all the quantitative performance criteria have been met during the program period, the transition from a centrally planned economy to a market economy has not been without severe hardships and sacrifice for the Lithuanian population. In the course of 1992-93, real GNP has been almost halved, while real incomes declined by more than 60 percent. Given the massive deterioration of the terms of trade, the collapse of trade with the former Soviet Union, and the effects of price liberalization, a major part of the real GNP fall reflects unavoidable structural changes.
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> My authorities are well aware that much still remains to be accomplished, not least in the structural area, but they believe that a firm foundation has now been made for a rebound of economic activity and of the living conditions of the population. Remarkable progress has taken place in many areas, with macroeconomic policies contributing to a sharp reduction in inflation and a firming of the exchange rate, while structural and institutional reforms have shown significant results, with far-reaching

privatization programs and the development of the banking system. Moreover, the official national accounts figures may overestimate the fall in production, as they do not fully capture activities in the growing private sector. In fact, goods shortages have largely been eliminated, and, in particular the level of activity in the services and manufacturing sectors may be higher than implied by the official data. Considering the widespread shortages under the Soviet system, there is a tendency to exaggerate the decline in living standards.

Even though substantial discussion has taken place as to the appropriate stance of economic policies, there has, on the whole, remained a broad consensus behind the main thrust of the present reform policies and the efforts to develop Lithuania, as quickly as possible, into an independent, marked-based economy. The present Government has a comfortable majority in the Parliament, and its comprehensive and medium-term oriented stance of economic policies--supported by the Fund--has demonstrated the authorities' determination to transform the Lithuanian economy. This is clearly manifested in its request for a new stand-by arrangement, which, in due course, is likely to be succeeded by an arrangement under the extended Fund facility. A main objective of the second adjustment program is to achieve noninflationary and broad-based economic growth. My authorities consider a low inflation environment as a prerequisite for such a development, and they concur that this will require a continued restrictive overall stance of economic policies.

The pickup of inflation in September 1993 seems to have been influenced by special factors, and the target remains to bring inflation down to single digits at an annual rate by late 1994. My authorities are therefore aiming at a modest general government deficit of not more than 1 percent of GDP in the second half of 1993 and in 1994, combined with prudent lending operations, within established ceilings, by the Government. The deficit and net lending would be predominantly financed from foreign loans, but domestic government bonds may also be issued to help finance the deficit.

Monetary policy will also continue to be geared toward lowering inflation. Interest rates will be established as the main instrument for the allocation of financial resources. Consistent with this goal, my authorities will not interfere in the setting of interest rates; nor will the Bank of Lithuania provide interest rate subsidies on new lending. In addition to the quantitative ceiling to be set on the net domestic assets of the Bank of Lithuania, reserve money will continue to be used as an indicative target. Given the many elements of uncertainty related to this indicator, e.g., changes in currency substitution as well as in commercial banks' holdings of excess reserves, the fluctuations of reserve money will have to be interpreted with some caution.

Considerable disagreement has existed among industrialists and politicians concerning the appropriate level of the exchange rate. For the time being, my authorities intend to maintain a floating exchange rate regime for the litas, and they will refrain from manipulating the floating rate in order to strengthen international competitiveness. However, owing to the significant initial undervaluation of the litas, the competitive position of the industrial sector is likely to remain satisfactory. Moreover, the markedly improved inflation performance has helped to dampen the appreciation of the litas in real terms. The recently established interbank exchange had its first trading on October 21, 1993, and it will replace the currency auctions, thus creating an effective mechanism for exchange operations in the interbank market. Although no target exchange rate will be set, the Bank of Lithuania may, from time to time, intervene to maintain orderly conditions in the exchange market.

Price liberalization is nearly completed, and heating subsidies will be reduced in steps until they are abolished by October 1, 1994. Owing to the problems with oil deliveries from the Russian Federation last winter, foreign funds have been used for advance purchases of oil for the coming winter season. Although the incomes policy has proven useful, and will continue through 1993, my authorities are concerned that it may, over time, exert a negative influence on productivity. The incomes policy approach will therefore be reconsidered in light of overall wage developments. The authorities will, however, continue to exercise restraint in setting public sector wages.

In light of the sharp fall in many people's standard of living, better targeting of benefits to the neediest groups is an important goal. While accepting the responsibilities in this area, my authorities consider it necessary to narrow eligibility for social assistance programs, and to undertake major reforms of the pension and unemployment systems.

During the past two years, major changes have taken place in Lithuania's composition of trade. While the importance of Western markets has strengthened significantly, the shift has been somewhat less marked than in Estonia and Latvia, in part reflecting Lithuania's continued reliance on energy imports from the countries of the former Soviet Union. Even though trade with Western countries is likely to further increase in relative importance--with Germany, Poland, the United Kingdom, and Sweden as the largest trading partners--my authorities consider it important to improve and revitalize trade relations with the countries of the former Soviet Union. It may, however, prove difficult to strengthen trade with the countries of the former Soviet Union before economic conditions become more stable.

In order to liberalize the trade regime, the dispersion of trade tariff rates will be reduced and export taxes will, for the most part, be eliminated in the course of 1994. Free-trade agreements with Belarus, Estonia, Kazakhstan, Latvia, and Ukraine, in addition to those with Finland, Norway, Sweden, and Switzerland, are expected to be of increasing importance, and negotiations with the Russian Federation, Poland, and Iceland on such agreements have recently been initiated. My authorities intend to apply for associate membership status in the EC and, in due course, to apply for full GATT membership. However, many countries, including such potentially important markets as the EC countries and the Russian Federation, are still imposing tariff and nontariff barriers on Lithuanian products. To accomplish the necessary transformation of the industrial sector it is essential that all countries open up their markets and refrain from protectionist measures.

Lithuania will continue to require substantial inflows of foreign financing for imports in the coming years, especially of investment goods needed to support the resumption of economic growth. The projected current account deficits for 1993 and 1994 are expected to be covered by loans from the EC/Group of Twenty-Four (G-24), the World Bank, the European Bank for Reconstruction and Development, bilateral creditors, private capital inflows, and, to a minor extent, from Fund purchases. Performance targets have been set on external government borrowing or guarantees in order to avoid excessive debt accumulation during the program period.

Good progress has been made in many areas of the privatization program. The privatization of the housing sector is actually completed. Over half of all agricultural land will belong to private owners by the beginning of next year, and about 40 percent of state capital intended to be privatized has been transformed to private ownership. Moreover, quite a few entities have been auctioned to foreign investors. However, problems remain in some areas, such as the restitution of land.

My authorities intend to improve and adapt the framework for commercial activity and enterprise reforms to the requirements of a market-based economy. This is essential for achieving an upswing in private investment, which is a prerequisite for the transformation of the Lithuanian economy. High-technology industries have traditionally accounted for a major share of Lithuania's industrial sector, and it is important that these industries adjust to the new competitive environment. Furthermore, measures aiming at restructuring and privatization of the financial sector will also be given high priority, and a stock market has recently been established.

In order to plan and implement the many domestic reforms, a number of areas where technical assistance will be needed have been identified. My authorities are grateful for all the assistance rendered so far by the Fund, the World Bank, and the EC, as well as by other international institutions and countries, and they look forward to further assistance in this field. In this context, they will give major attention to achieving coordination of all aspects of technical assistance.

Finally, my authorities want to express their sincere appreciation for the continued excellent cooperation with the staff mission team, as well as the resident representative and other Fund staff. The policy advice and technical assistance provided to Lithuania over the past year have been invaluable.

Responding to a question, Mr. Solheim said that the central bank Governor had been suspended from his duties owing to disagreements with other members of the Government. That step had been taken because of a lack of confidence in the Governor.

Mr. Kagalovsky made the following statement:

During the period of the first stand-by arrangement, Lithuania achieved impressive stabilization results. The observation of all the quantitative performance criteria and the completion of the Article IV consultation confirmed the prudent stance of financial policies. We welcome the ongoing progress in financial adjustment--especially the deceleration of inflation from 14 percent in the first quarter of this year to less than 1 percent in August--as well as the visible strengthening of the newly introduced national currency. These important achievements clearly show the success of the program supported under the first stand-by arrangement.

As for the current program in general, it is commendable that GDP is expected to stabilize in the second half of 1993. It is noteworthy that real wages were kept in strict compliance with the actual performance of the economy: the decline of GDP through 1993 is estimated to be 15 percent, with a decline in industrial output of about 42 percent, while real wages in 1993 are estimated to be 45 percent lower than in 1992. However, in April, at the time of the Article IV consultation, the decline in GDP was projected at 5 percent; then in June, at the time of the review under the first stand-by arrangement, it was revised and projected at a level of 10 percent. Now, the decline is assessed to be 15 percent. I hope that the staff can share with us the reasons for the changes in the estimates.

As to fiscal policy, a surplus in the consolidated budget was achieved, owing primarily to expenditure control, in particular by the previously mentioned containment of wages and broad-based expenditure cuts. Still, the budget remains structurally fragile; for example, if we analyze its dynamics, subsidies, which were reduced during 1992 from 5.4 percent to 2.1 percent of GDP, are now on an upward trend of 2.7 percent for the first half of 1993 and 3.3 percent for the second half of 1993. There are no comments in the staff report on this reverse movement, and I would appreciate some additional elaboration.

Prudent domestic financial policies in their turn reinforced the national currency. What is worrisome in this respect is that gradual real appreciation of the exchange rate of the litas vis-à-vis the currencies of Lithuania's major trade counterparts increased pressure from import competition and, as I understand it, intensified demands for protectionism. The picture is not quite clear in this area. On the one hand, the authorities are committed to unifying the import tariff structure at the level of about 10 percent. On the other hand, earlier, in their attempts to replace the former central coordination of trade flows, the Government created a whole web of bilateral "free-trade agreements" with five of the states of the former Soviet Union. Usually such free-trade agreements are very selective toward different commodity groups, with the virtual absence of import duties on some of them, and with different exemptions on centralized trade at overlevied duties. The staff report is not pronounced enough on whether the terms of bilateral agreements are in compliance with the task of unification of the import regime and, if not, what measures are envisaged. Information, provided in the supplement circulated yesterday, proves that the authorities have moved toward large disparities in import tariffs as a temporary measure, although they are still committed to establishing a uniform import tariff. Comments on the reasons for this apparent inconsistency are also welcome.

My most serious concerns are about the structural policies. At the time of the review under the stand-by arrangement, the absence of a coherent strategy of financial sector reform was stressed by many Directors. In the new program, this issue is almost not addressed. Weaknesses in the financial sector, and in particular in the banking system, are obvious today. The staff notes on page 16 that because of "the inability of the banking system to absorb the large flow of external funds expected in the program period, substantial net lending by the Government from these funds has been targeted."

As for the real sector, the report assures us that privatization, except for land privatization and restitution, is complete. Let us be very clear about this area: as in many other transitional economies, privatization in Lithuania was conducted under the voucher scheme. This is a speedy and efficient way of transferring property rights from the public companies to the private sector; however, this is only the first step, which is aimed only at paving the way for real industrial restructuring. The interenterprise arrears are mounting, thus making the restructuring of the financial sector more problematic. Though Mr. Solheim's statement mentions that "measures aiming at restructuring and privatization of the financial sector will also be given high priority," this is not quite evident from the program itself, and elaboration by the staff on this issue would be welcome.

Lithuania is requesting a second stand-by arrangement and an initial purchase under the STF. The comprehensive statement by Mr. Solheim states that the country's main objective is "to achieve noninflationary and broad-based economic growth." As for inflation, it had already been reduced to less than 1 percent. Against the background of the impressive stabilization achievements, the structural reform remains in its infancy. Meanwhile a significant contribution to "broad-based economic growth" could come from structural efforts releasing the potential of the enterprise and financial sectors.

With these remarks I support the proposed decisions.

Mr. Oya made the following statement:

I welcome the successful completion of the preceding stand-by program with the authorities' observance of all the performance criteria. I also commend the authorities for the excellent economic performance. Over the past year, the authorities have implemented all the measures for economic reform incorporated in the stand-by arrangement and have produced good results in many fields, including the containment of inflation, price liberalization, and the privatization of enterprises.

The second adjustment program contains many measures that extend and strengthen those of the first program. I would like to emphasize that it is essential to fully implement the present program in order to ensure the success of the economic reform and the smooth transition to an extended arrangement, as the authorities wish.

Regarding the implementation of the present program, I would like to mention some points to keep in mind. First, as the staff points out, the main program goals are to raise real growth to the sustainable medium-term potential of the economy, while reducing inflation to single digits by late 1994. I believe this goal is correct. However, I would like to emphasize that an increase in real growth should not be pursued at the cost of price stability. Recent indicators show that inflation has been contained. However, as evidenced by the increase to more than 4 percent in September 1993, it is too early to relax the current prudent financial policy, and it is still necessary to remain vigilant against a resurgence of inflation.

Moreover, I believe growth and price stability are compatible, because the authorities expect that declining inflation will expand the scope for reducing nominal interest rates, which should stimulate growth. With respect to the decline in interest rates, the authorities should not interfere in the setting of interest rates, because interest rates need to be established as the main instrument for the allocation of financial resources, as Mr. Solheim's statement rightly points out. It is encouraging, therefore, that the authorities expressed their intention to refrain from intervening in the setting of interest rates and not to provide interest rate subsidies on new lending.

It is also necessary that the authorities aim monetary policy at protecting the value of the litas on foreign exchange markets. Although the effective measures implemented by the authorities have led to an appreciation of the exchange rate, the litas was introduced only four months ago and should be monitored carefully in the period ahead.

On structural policy, I am concerned that the progress of land reform has been delayed. Problems remain, especially in the restitution of land, and there do not seem to be any measures in the program to accelerate the progress. The staff's comments on what is delaying the progress on restitution of land would be appreciated.

Lithuania was the first of the former Soviet Union states to be a Fund member. It was also one of the first of the countries of the former Soviet Union, together with Estonia and Latvia, to reach an agreement on a stand-by arrangement with the Fund. In addition, it played the role of pioneer in the introduction of a national currency, providing important lessons to other states of the former Soviet Union. The recent economic situation in Lithuania is proof that all these courageous decisions were absolutely right. I believe that the authorities' correctness of judgment and their eagerness to undertake the economic reforms will result in Lithuania's economic success.

Needless to say, eagerness alone does not result in successful economic reform. I especially commend the authorities' administrative capacity, which has contributed to the implementation of all the measures in a very short period. Undoubtedly, the technical assistance provided by the Fund played a major role. I believe that other countries that are implementing economic reform should pay more attention to the importance of building up administrative capacity.

I hope that Lithuania will persevere with the current economic reform policy and continue to be an example of successful economic reform.

With these remarks, I support the proposed decisions.

Mr. Posthumus made the following statement:

Two years after gaining independence and having already successfully completed one stand-by arrangement, the transformation process of Lithuania's economy is now safely on course, I hope. The private sector, although still modest in size, appears to be expanding rapidly. External trade is reorienting, as markets outside the countries of the former Soviet Union are gaining in importance. Monetary independence has been achieved, and there is growing confidence in the litas, the new national currency. All these developments are indications that the structural transformation is taking effect. Furthermore, Lithuania's economy is beginning to recover from its abrupt decline in the wake of the initial reforms and the collapse of the former trading structure. Of late, the economy is also showing signs of stabilization.

It is worth pointing out, however, that in some areas reform is falling behind and would require particular attention under the forthcoming arrangement. High priority should be given to restructuring the financial sector, which, as yet, is very shaky on its legs. There is the generic problem, common to many of the formerly centrally planned economies, of the nonperforming assets in the state banks' balance sheets. Furthermore, the financial stability of the commercial banks is weak, because they had entered into large open positions in foreign exchange before the tightening of monetary policy and the hike in interest rates. For the viability of the commercial banks and the stability of the financial sector, there is clearly a need to review the prudential regulations and implement efficient banking supervision. Furthermore, the sector can operate efficiently only if it becomes competitive, and if a critical mass of state banks is privatized. I am dwelling on this point, because a sound financial system is a prerequisite for the efficient conduct of monetary policy and, therefore, is a cornerstone of a well-functioning market economy.

It is because of the present limited capacity of the banking system that the Government, rather than the banking system, will be lending on the loans that Lithuania has been granted by the EC/G-24. This is clearly a suboptimal way of financing investments and entails the further risk of reverting to the erstwhile control policies, thereby defeating the whole objective of these loans. Also, investment decisions that are taken administratively are likely to give rise to moral hazard and could therefore impinge on the credibility of the economy as a whole. Could the decision to funnel the EC loans by the Government be reversed if the authorities and the staff are satisfied that the banking system has become capable of handling this operation?

Finally, the staff unnecessarily hides one of Lithuania's lights under a bushel. The introduction of the litas, the new currency, has been completed since the second review of the previous stand-by arrangement. It was an important and, it seems, successful operation. But only a few lines are devoted to it on page 5. A more comprehensive report on the operation would also be useful for other members of this institution.

But there is more under this bushel--namely, exchange rate policy--and I would like to see it. A year ago, the staff said that, for the near future, a floating exchange rate would be maintained but, in due course, there would probably be a peg. No explanation is provided of exchange rate policy at the beginning of this stand-by arrangement. The nominal exchange rate depreciated very sharply at the beginning of this year, and it has appreciated since June. Is it expected that the appreciation will continue with the present monetary policy? Mr. Solheim's statement makes it clear that there is discussion in Lithuania on the appropriate level of the exchange rate. The authorities do not appear to have a target exchange rate in mind. What is the staff's view on the authorities' statement that monetary policy is directed at reducing inflation to single digits at an annual rate by late 1994 and at protecting the value of the litas on foreign exchange markets? What is the staff's advice on exchange rate policy in this case?

Mr. Desruelle made the following statement:

At the outset, let me commend the authorities for the many positive actions taken under their first stand-by arrangement, which have resulted in favorable developments on a number of fronts. In particular, in recent months, thanks to fiscal discipline, a firmer monetary policy, and a tight incomes policy, inflation has declined significantly below the average of the first half of 1993.

At the same time, the implementation of these macroeconomic policies and of structural measures, such as the privatization of enterprises, the liberalization of the trade regime, and the opening up of the economy to foreign investment, are creating conditions for a positive supply response. The stabilization of overall output expected this semester and the growth of private sector activities are encouraging signs in that regard.

The main challenges the authorities now face are to consolidate the results obtained in the area of macroeconomic stabilization and to keep building an economic environment conducive to a strong and sustained recovery of growth. The economic program, presented to us today, certainly addresses these challenges. I, therefore, agree with the thrust of this program and fully support the authorities' request for a stand-by arrangement and a purchase under the STF.

This being said, let me make a few remarks on some specific aspects of the program. First, on fiscal policy. For 1994, the program calls for a very moderate financial deficit; it also calls for increased capital expenditures, both directly and through net lending operations. Given the dual goals of macroeconomic stabilization and growth, this is fully appropriate.

To fulfill these goals, it will be essential to achieve the programmed increase in tax revenues and reduction in current expenditures. As regards revenues, this will require that the authorities adhere to their commitment to give the planned value-added tax a very broad base; it will require as well that all the necessary arrangements be made to ensure a smooth transition from the present general excise tax to the value-added tax so as to avoid any temporary fall in revenues.

As to expenditures, given the large share of social outlays in current expenditures, focusing social benefits on the neediest groups and reforming pension payments are essential to contain current expenditures. The authorities are therefore urged to pursue their efforts in these areas. At the same time, in addition to measures designed to reduce costs, reform of the social safety net could also be reoriented in favor of instruments that facilitate the ongoing restructuring of the economy. In this regard, I wonder whether the proposed reduction in unemployment benefits, while having a positive impact on the fiscal situation, might not dampen the necessary adjustment to employment in enterprises. I would appreciate comments by the staff on this matter.

Now, some comments on monetary policy and the control of inflation. First, I observe that the ceiling placed on the growth of the central bank's net domestic assets and the limit on the growth of reserve money are compatible with a gradual reduction in inflation during the course of the program.

Second, I note that, as explained in Supplement 1 to the staff report, movements of the exchange rate have a significant and rapid impact on the evolution of inflation. Of course, this is not surprising, given that the Lithuanian economy's exposure to trade is high, the ratio of imports to GNP exceeding 50 percent. Given the flexible exchange rate policy currently followed by the authorities, the burden of controlling inflation, and of avoiding an inflation/devaluation spiral, rests fully on domestic policies. It thus requires strict implementation of the programmed monetary policy, as well as a conservative fiscal stance. At this stage, given that financial discipline of enterprises is still weak--as shown by their attitude toward arrears--the pursuit of the present incomes policy appears necessary as well.

Third, while I agree with the monetary policy targets in the program, I would like to raise one issue regarding the implementation of monetary policy. I note, on the one hand, that direct credit controls on individual commercial banks are to be dropped in favor of indirect monetary instruments. On the other hand, the wide array of measures to be taken under the program to restructure the financial sector and to strengthen its supervision by the central bank points to the present weak state of the banking system and the current imperfect enforcement of prudential requirements. On this point, I fully agree with the remarks made by Mr. Kagalovsky and Mr. Posthumus.

Given that a monetary policy based on indirect instruments can work efficiently only if the banking system reacts to price signals, and given that this will be the case only if the banking system is sound, I wonder whether the shift to indirect instruments of monetary control should not be approached more cautiously. In particular, this shift, which is ultimately desirable, could be more closely tied to progress on strengthening the banking system, as specified in the program. I would appreciate comments by the staff on this issue. Of course, a more cautious attitude in this respect should not alter the goal of moving to a positive real interest rate structure.

Let me now turn to the external sector, starting with exchange rate policy. As noted above, fluctuations of the exchange rate complicate the task of reducing inflation, and place the whole burden for that task on domestic policies. One is therefore tempted to ask whether exchange rate policy could not play a more forceful role in favor of stabilization, as, for instance, has been the case in Estonia. It seems to me that various elements point to the viability of such a reorientation of policy.

First, although the current account deficit is currently fairly high, there does not seem to be any indication of an overvaluation of the exchange rate. On the contrary, as Mr. Solheim stated, "given the significant initial undervaluation of the litas, the competitive position of the industrial sector is likely to remain satisfactory;" there could then be some room for a real exchange rate appreciation while Lithuania's inflation rate was being brought down to the level of its Western partners.

Second, the staff projections, which, I understand, are based on a constant nominal exchange rate, forecast a progressive elimination of the current account deficit by 1998, by which time Lithuania's external debt would be less than 20 percent of GDP. Furthermore, it is expected that, with a sound policy environment, currently estimated financing gaps could be filled by additional official and private flows.

Third, the present level of international reserves seems appropriate for such a strategy.

I would add that such a policy could, in itself, spur capital inflows by speeding up stabilization of the economy, thereby enhancing foreign investors' confidence. I would welcome comments by the staff on this issue.

Finally, a word on other external policies. The authorities should be commended for the adoption of a new trade regime, and especially for the elimination of export quotas. They are now encouraged to move ahead with their plans to achieve a uniform tariff rate and elimination of all export taxes. These measures, the trade agreements that have been signed or are under negotiation, and the efforts to attract foreign capital should, combined together, be one important factor in generating output growth.

With these comments, I support the proposed decisions.

Mr. Dorrington made the following statement:

Lithuania has achieved a great deal over the past year. At the same time as it has reformed its political system, it has pursued its stabilization program diligently, and the benefits are increasingly clear. GDP is expected to stabilize in the second half of the year, with positive growth forecast for 1994, but in reality there may be positive growth already, given the weakness of statistical data on private sector activity. Progress on reducing inflation through tight monetary and incomes policies has been impressive, and Lithuania is now broadly matching the inflation performance in Estonia and Latvia. Fiscal policy remains tight, and confidence in the new currency has been established. The process of market reforms has been reinforced by successful privatization, and trade has been successfully liberalized and reoriented toward nontraditional markets.

All this is very welcome news, indeed. Lithuania now has, as the staff appraisal highlights, a clear opportunity for noninflationary growth with rising productivity over the medium term. But to achieve this, the authorities will need to persevere in their reform efforts. There have been, and will be, strong internal pressures to relax the current policy vigor; these may be stronger than the staff suggest, and the news this morning runs the risk of increasing uncertainty, although I noted here the reassurance from the Prime Minister, which, in the circumstances, I am inclined to take at face value.

Reinforcing the success of economic reform to date will also be crucial to generate the foreign capital inflows needed. In particular, the Government's resolve to achieve price stability should be reinforced. The staff acknowledges that, under the previous stand-by arrangement, inflation was much higher than programmed, and the low August figure was to some extent seasonal--a point clearly demonstrated by the rebound in September. Further inflationary pressure is likely to result from the removal of heating subsidies and the end of the formal incomes policy. There also appear to be growing political impediments to a tight monetary policy, as demonstrated by the reaction to the tightening of monetary policy earlier in the year, ahead of the introduction of the new currency.

Continuation of a tight fiscal position is a necessary condition for success, particularly given the lack of nonmonetary financing instruments. I therefore welcome the plans to widen the revenue base through the introduction of a value-added tax and by improving the targeting of welfare payments. However, the Government's system of constraining expenditure by continued downward pressure on social and wage expenditure may not be sustainable in the longer term. I am aware, for example, of mounting pressure for a reversal of some of the spending cuts that gave rise to the budget surplus in the first half of 1993; I would therefore urge the authorities to place more emphasis on enhancing revenues, in particular through improved tax collection. There is also a need for the Government and the central bank to work together in developing nonmonetary deficit-financing instruments.

I was disappointed to see that relatively little progress has been made on the issue of interenterprise arrears; at two thirds of the broad money supply, this represents a major problem. The continuation of the practice of enterprises supplying traditional customers irrespective of the prospect of payment will only exacerbate this. Could the staff please say what steps are being taken to deal with this? Also, do the staff have any comments on the decree recently signed by President Yeltsin converting Russian interenterprise debts into promissory notes in an attempt to deal with this problem in Russia? Might there be benefits for Lithuania of adopting such a scheme?

Turning to structural measures, I welcome the extension of the privatization program; all possible steps should be taken to accelerate the implementation of the bankruptcy law ahead of mass privatization, and this should also help with the problem of interenterprise arrears. Also, more progress needs to be made in land restitution. I welcome the intention to restructure the banking system and to privatize state banks by the end of 1994, and I agree with the comments of other speakers on the importance of this. Priority needs to be given to effective enforcement in cases in which banks fail to meet prudential standards. On trade, there remains a clear disincentive to exporters at a time when the external position needs to improve. I would therefore urge the authorities to press ahead quickly with the review of export taxes planned for 1994, with a view to eliminating them.

With respect to exchange rate policy, Mr. Posthumus has asked all the questions I had in mind and, indeed, more besides, so I have no need to dwell on that.

The large share in anticipated external debt levels of Fund credit in particular, and international financial institution credit in general, is to be expected at this stage of the transition process, and I recognize the relatively low level of external debt overall. But the figures given on page 12 and in Tables 9 and 13 of the report do not include the effect of a possible follow-on extended arrangement. This situation will need to be monitored closely, and I would be interested in the staff's estimates of Fund exposure as a percentage of the total, assuming an extended arrangement follows on from this stand-by arrangement, and the staff's comments on whether there is a risk of heavy bunching of repurchase obligations. Of course, we all hope that, by the time that Lithuania will be having to cope with repurchases, it will also be having to cope with the so-called problem of large capital inflows.

My remarks today have contained many comments on the need for perseverance and caution, and fewer by way of congratulation. This is not because the achievements to date have not been impressive, but because I am concerned that they should be built upon rather than allowed to start evaporating. This stand-by arrangement should provide some cement for that building process, and I have no hesitation whatsoever in supporting the proposed decisions.

Mr. Lanciotti made the following statement:

The Lithuanian authorities are in the midst of a difficult and complex transitional process, and they are to be commended for their consistent pursuit of economic reform in the face of adverse external shocks. The present policy stance points in the right direction, toward successful adjustment in the future; difficult choices remain to be made, however. The staff paper paints a promising picture of the results achieved by Lithuania under the recently concluded stand-by arrangement. In fact, all the performance criteria were met, and the fall in output as well as the relatively poor performance on the inflation side during the program period should not overshadow the authorities' economic performance. I am in broad agreement with the staff appraisal of the short- and medium-term prospects and with the current policy priorities as set forth in the memorandum of economic policies. I therefore endorse Lithuania's requests for a stand-by arrangement and for a purchase under the STF, with the following remarks.

Structural reform must proceed hand in hand with macroeconomic stabilization in order to achieve successful completion of the adjustment effort. Indeed, progress on the structural front is as important as that made on the macroeconomic front. Judging from the Lithuanian authorities' agenda, they seem to be well aware of this necessity. It is heartening that fiscal and monetary policies will continue to be geared to the task of controlling inflationary pressures, while ensuring adequate liquidity to preserve a sustainable level of economic activity. The pressing need to reduce inflation requires a tightening of credit policy in order to contain growth in total liquidity. On the one hand, use of reserve requirements to achieve this aim is most appropriate, and the authorities are encouraged to carefully watch their strict enforcement, in order to eliminate possible excess reserves. On the other hand, I recommend, at least for the time being, the retention of the option of applying more direct instruments of control--like the imposition of a ceiling on the domestic assets of the central bank. On the reform of the financial sector, I cannot but echo the remarks of Mr. Posthumus. This reform is, in fact, badly needed, as is the establishment of an efficient banking system, before reliance on purely indirect monetary instruments can be considered. I note with satisfaction that a number of measures to this aim are envisaged in the memorandum of economic policies.

Rationalization of the interest rate structure and achievement of positive real interest rates, as well as reallocation of credit to the emerging private sector, are also crucial. Of course, a larger share of credit can go to the private sector only if the financing needs of the public sector are reduced. For this to take place, restructuring of state enterprises is to be firmly pursued. A vigorous program of enterprise financial discipline is warranted, in order to prevent enterprise arrears from undercutting the stabilization effort. In the area of fiscal policy, I have some problems with the weakness of the public enterprise sector and the long time necessarily involved in its full restructuring. I urge the authorities to speed up the whole process, so as to avoid having the negative performance of such enterprises jeopardize the prospects for the re-establishment of domestic financial equilibrium.

With respect to the state budget, rationalization and prioritization of government expenditure have to be firmly pursued. Over the medium term, enhancement of revenue performance will be crucial to mobilizing the public savings needed for investment and growth. For this to be a realistic objective, simplification of the tax system, broadening of the tax base, and improvements in tax administration are in order.

The medium-term outlook for Lithuania is steadily improving but is still uncertain, as highlighted by the financing gaps remaining until 1996. It is therefore all the more important that the present economic program be implemented as firmly as the program under the previous stand-by arrangement. The program rests on a sound and comprehensive policy framework, where well-specified macroeconomic and microeconomic measures are coherently designed to address the objectives of economic stabilization and faster output growth. The commitment of the authorities to its implementation will be the best guarantee of timely support by the international financial community and no doubt deserves our institution's support.

Mr. Laux made the following statement:

The previous stand-by arrangement with Lithuania had a bumpy start, and it is therefore very satisfactory that the document before us confirms the findings of the previous program review, namely, that Lithuania has finally joined the other Baltic states in making meaningful and significant progress toward stabilization. Inflation has come down significantly--I hope that the September data do in fact reflect special factors--the introduction of the new currency has no doubt been a success, and the balance of payments situation has improved considerably.

Lithuania was able to overcome the policy weaknesses experienced in the first few months of the previous stand-by arrangement, and the success so far should provide the basis for sustained recovery. The lesson, of course, is that the best policy is to build on these achievements and to proceed on the now well-established path of financial stabilization.

I therefore welcome the program before us, as it focuses correctly on maintaining the momentum of stabilization, while proceeding with structural reform to trigger the needed supply response. The program appears well balanced, and I have no difficulty in supporting it. I also could go along with the idea of negotiating an extended arrangement before the expiration date of the proposed stand-by arrangement, once it has been successfully demonstrated that the stabilization successes so far are permanent. An extended arrangement would be helpful, as most of the outstanding reform issues are structural in nature. It should be designed in such a way that, after successful completion of this arrangement, there will be no further need for the financial involvement of the Fund.

Turning to the program, I have no particular difficulties with the budgetary and monetary parts. In particular, I would like to welcome the authorities' intention to refrain from any substantial use of domestic bank credit to finance the budget. At the same time, it is important that the methods applied to keep budgetary developments under control so far--the relatively indiscriminatory squeeze on expenditure--be replaced by a more rational system of expenditure control that reflects carefully selected priorities.

There are two technical points I am curious about. First, on the budget, like Mr. Kagalovsky, I noted that the ratio of subsidies to GDP is expected to rise in 1994 notwithstanding the announced reduction in home heating subsidies, and I would like more information on this point. Second, I noted that all the budget figures in relation to GDP have been revised downward substantially in this paper compared with the previous ones, and I do not fully understand the reason for this revision.

On monetary policy, it is not clear to me how far the structural changes in the money demand function have gone, and it is therefore very important to monitor developments in money velocity very carefully. In this context, the exchange rate might increasingly play a role as an important indicator of the stance of monetary policy.

On structural reform, the agenda is certainly large, and one of the prerequisites for an acceleration of growth is a change in the behavior of state enterprises. But it seems doubtful at the moment that this change toward greater financial responsibility has started. The staff points out that interenterprise arrears reached a level of two thirds of the money supply at end-July 1993. The paper does not say whether interenterprise arrears are still rising, or whether this process has come to a halt. What is most disturbing, however, is the fact that enterprises were prepared to supply customers even if it was clear that there was no prospect of timely payment. That definitely demonstrates that there are severe weaknesses in the management of these enterprises. It is therefore all the more important that the authorities refrain from any large-scale bailing out of failing enterprises by clearing arrears through credit creation. At the same time, it appears that more has to be done to communicate to state-owned enterprises that they cannot count on an easy way out of arrears.

In this context, the importance of the timely implementation of the bankruptcy law regulations cannot be overstated, and I am pleased to note that the necessary elements to make the law operational are expected to be in place by the end of this year. I am disappointed that this will not happen earlier. Work on bankruptcy procedures certainly is probably the most effective tool to enforce financially responsible behavior by state enterprises. However, given the fact that creditor enterprises have been quite happy so far to pile up doubtful claims on other enterprises, I would like to know whether these bankruptcy procedures include automatic initiation of bankruptcy procedures, as, for example, in the case of Hungary.

In general, the persistence of the arrears problems underlines the fact that the transformation of the traditional, or "old," enterprise sector is still at a very early stage, and I therefore wonder whether the abolition of the incomes policy is not somewhat premature, at least for state enterprises. The rationale for wider wage differentiation is of course perfectly justified. Nevertheless, the authorities should stand ready to take action, if there is any indication that average wages rise faster than productivity.

Finally, the state's involvement in the distribution of foreign credits among enterprises might be unavoidable, given the weaknesses of the banking system. In this context, I would like to reiterate two points I made during the previous discussion on Lithuania: it is not the speed at which money is spent that counts, but the quality of the investment it is used for; and I hope that the Lithuanian authorities make sure that the external money is wisely spent.

I, like other speakers, would reiterate the importance of establishing a workable and efficient financial sector. I am not sure that it is correct to say that there has been no progress; I found that the program contains many financial sector reform measures. I am particularly pleased to note the progress in the privatization of state banks.

Mrs. Hetrakul made the following statement:

The Lithuanian authorities are to be commended for the remarkable progress that has taken place in the space of a year. The authorities' determination, as expressed in Mr. Solheim's statement, to vigorously continue their program of structural and institutional reform, while maintaining stability through the implementation of prudent fiscal, monetary, and exchange rate policies, is also encouraging. With some technical assistance and external resources from the international community, I believe that Lithuania should be able to establish a sound basis for renewed growth in a low-inflation environment. I concur with the basic thrust of the staff appraisal, and, therefore, I shall limit my statement to a few brief remarks for emphasis.

The program's main goal of raising real growth to the sustainable medium-term potential of the economy, while reducing inflation to a single-digit annual rate by late 1994, is ambitious but attainable, if the measures specified in the 1993-94 program are fully implemented. In my opinion, the performance limit on the general government deficit is necessary. I, therefore, welcome the measures to adjust both expenditures and revenues.

On the expenditure side, I agree that the reduction in government subsidies, the prioritization of expenditure, as well as the careful planning of social benefits, would assist in scaling down government expenditure. Experience in other countries shows that social benefits, once introduced, will always remain a major government expenditure. Therefore, they should be carefully designed to match each country's budget constraint. On the revenue side, the introduction of a value-added tax, with a wider base, and reform of the tax administration should increase revenue for the Government.

The introduction of the litas as the national currency, as well as the policy of floating the exchange rate without a target rate, is very courageous. Even though they may be difficult at first, these steps are in the right direction. Furthermore, I am in favor of market-determined interest rates, with no subsidies. The authorities should speed up financial sector reforms and develop additional monetary instruments in pursuit of an independent monetary policy. At the same time, they should move along with the privatization of commercial banks and the full implementation of the bankruptcy law to provide an efficient allocation of resources and a sound environment, as well as to create confidence for investors.

Turning to external developments, the more liberal trade regime is particularly welcome. I urge the authorities to review the export taxes with a view to phasing them out speedily, as these measures produce disincentives to exporters. In this respect, I encourage the Lithuanian authorities to open up their country to all countries, be they Baltic, states of the former Soviet Union, European, Western, African, or Asian. The authorities should press ahead with their efforts to make Lithuania a full member of the GATT, while diversifying traditional markets and products. In this connection, export markets will be widened, and cheaper imports will be made available for domestic consumers.

Finally, on the subject of structural reform, while several reform measures were taken and progress was made, particularly in privatization, steps to improve restitution of land are proceeding too slowly. I urge the authorities to aim at completing the process within a shorter time span.

With these remarks, I can support the proposed decisions.

Mr. Ryan made the following statement:

Lithuania's journey from central planning to a market economy continues to make solid progress. Although the transition has involved substantial hardships, the authorities are to commended for managing the process in a generally sound manner. As a result, Lithuania appears to have begun to turn the corner in stabilizing the economy, a key step in moving the economy forward to a sustainable, market-led growth path. Plenty of challenges remain, of course, but an improved macroeconomic environment and the tenor of the reform policies and objectives outlined in the staff report and the memorandum of economic policies offer fresh encouragement.

The economic contraction experienced by Lithuania has been severe over the past two years. Measurement problems aside, there is no question that output and real wages have declined substantially. As both the staff and Mr. Solheim's statement indicate, much of this decline was probably unavoidable, given the terms of trade shocks, the collapse of trade with the former Soviet Union, and the effects of price liberalization. Against this backdrop, the authorities have done a good job of resisting the temptation to deflect the impact of these adjustments through increased wages, subsidies, or other short-term palliatives. The decision to hold to a moderate line on public sector wage growth earlier this year, despite the erosion in real incomes caused by inflation, was a case in point--a necessary decision made in difficult circumstances. More generally, the authorities have pursued a tight fiscal stance, achieved under the previous program through a commitment to fiscal balance under which outlays were limited to receipts. This has contributed to a clear orientation toward macroeconomic stability that has been enhanced greatly by commendable actions on the part of monetary authorities in moving toward indirect monetary controls and reducing price pressures.

These efforts have begun to take hold. The monetary tightening, which began in the spring and paved the way for the introduction of the litas in early summer, has seen inflation decelerate substantially and the exchange rate strengthen. Real wages have stabilized. One would expect, as noted in the staff paper, that lower inflation and reduced uncertainty regarding financial policy performance would serve to boost confidence and spark investment. These factors, combined with the recovery in the agricultural sector, adequate energy supplies, and new external financing, suggest that some of the pieces of the growth puzzle may be falling into place. Moreover, as has been noted, there are two caveats--one quantitative, the other qualitative--to the national account figures describing the magnitude of economic decline that has taken place. One is the fact that private sector activity is likely undercounted, possibly by as much as 10-15 percent of total output, according to the staff. Second is the fact that goods shortages of the past have been largely eliminated; production has declined during the transition, but its composition, as well as imports, are increasingly market driven. Thus, as Mr. Solheim notes, the link between living standards and the recorded drop in GDP would appear to be somewhat attenuated.

That being said, much remains to be done, particularly on structural reform, if the growth potential is to be realized. Maintaining the momentum of privatization measures will remain important. The memorandum on economic policies points up the substantial number of enterprises that have been privatized. From the table on real economic indicators, the actual share of employment accounted for by private firms amounts to some 40 percent. The actual figure could be higher. It is almost certainly true that the share of output produced by these firms is significantly higher. Good progress has been made, but the continued accumulation of interenterprise arrears points up the need for continued efforts.

At the same time, privatization alone is no panacea. Underlying institutions and conventions needed to support viable firms must be in place, including the legal codes and machinery needed to give confidence to market transactions, adherence to accepted accounting practices, and development of sound financial sector. Clear challenges remain in these interrelated areas.

The financial sector has not yet developed the intermediation role necessary to support a vibrant economy. This is discouraging, especially when the Government feels it necessary to step in and fill the gap, as it intends to do in overseeing the lending of external disbursements from various official creditors. Clearly a second-best solution, this arrangement, involving the State Liabilities Commission, highlights the need for accelerated action in a number of problem areas, particularly regarding prudential requirements, supervision, and enforcement. Authorities appear to recognize the need to address existing shortcoming expeditiously, so we look forward to swift action. The move to a two-tier banking system and indirect monetary control offers a clear break with the inefficiencies of centrally allocated credits. This crucial step in the transition process must not be undermined nor monetary credibility potentially compromised by delays in bolstering the banking sector.

Similarly, the establishment of an equities market is a welcome development, but one which will also rely on the adoption of appropriate regulatory and accounting practices to ensure success.

Moving to the external sector, continued consolidation of the macroeconomic framework and structural improvements should position Lithuania well to take advantage of new trade relationships as well as to attract foreign investment. The current account continues to see a shift in the direction of trade toward Western markets. At the same time, the share of trade from the states of the former Soviet Union remains substantial, particularly regarding energy inputs. The boost in energy prices toward world market levels has contributed to the current account deficit. Unfortunately, electricity exports continue to lag behind world prices. We would be interested in more elaboration of this continued discrepancy, which appears to impose an artificial terms of trade loss on Lithuania. Given the potential adverse impact on Lithuania's medium-term outlook of a prolonged delay in raising electricity prices to market levels, some rationalization of existing arrangements would appear highly desirable.

Recent measures to liberalize Lithuania's trade regime, along with trade agreements with European as well as members of the Commonwealth of Independent States, should serve to enhance the diversification of Lithuania's trade relationships. Along these same lines, the planned development of an offshore oil terminal should serve to provide additional stability to energy supplies.

Continued widening of the current account deficit is expected as growth and import demand pick up. Securing sufficient external financing over the medium term will depend on sustained performance under the reform program. Private capital flows should play an increasing role in meeting financing needs as investment opportunities emerge and a track record of solid policy performance is established. The current exchange rate policy appears broadly in line with this objective--retaining flexibility while also seeking to smooth out market developments. More attention by staff to this policy approach, as others have suggested, might be useful.

In closing, we agree with the staff that Lithuania is now poised for renewed growth, and that, with continued progress on reforms and support from the international community, its need for exceptional financing ought to be eliminated in the not too distant future. We can support the proposed decisions.

The staff representative from the European II Department noted that the present real GDP growth forecast for 1993 was minus 15 percent, compared with the April forecast of minus 5 percent. Of course, forecasts were forecasts, but two factors in particular probably accounted for at least some of the difference between those two growth forecasts. One was that price stabilization had been delayed in comparison with the original expectations; it was only recently that the anticipated sharp decline in the rate of inflation had actually occurred. The rate had remained much higher than expected until almost mid-1993, and that might have delayed the stabilization of output, which had occurred later than the staff had initially anticipated. That development significantly affected the annual GDP forecast. The second factor was that the promised foreign financing had not materialized until the end of July 1993--significantly later than anticipated.

The subsidies in the present budget were larger than the subsidies in the previous budget, but, in terms of GDP, the difference was not large, the staff representative commented. Until recently, there had been cross-subsidization of energy for heating, as the household sector had been subsidized by the enterprise sector. The prices for the enterprise sector had recently been reduced, but the budget carried the reduced heating subsidy for the household sector; that was why the figure for subsidies in the budget had risen even though the total subsidy to the household sector had been reduced. Eliminating the subsidy would have been unrealistic at the present stage, although the expectation was that it would be further reduced or eliminated altogether in the course of 1994.

There had been pressure, particularly from the agricultural sector, for some increase in tariffs on certain imports, which were listed in the supplementary paper, the staff representative said. The Government had made it clear that that relief would be temporary, and that the authorities still intended to move to a unified import tariff with, as the authorities had said in their memorandum of economic policy, "few exceptions." The import tariff system was to be one of the areas examined during the next review of the program.

Lithuania maintained free-trade agreements, under which imports from the countries concerned were not subject to a tariff, the staff representative noted. Accordingly, in that sense, the tariff system was not a completely uniform one.

Page 53 of the staff report mentioned a number of steps that were planned in the area of financial restructuring, the staff representative remarked. Those steps would involve not only the Fund but also the World Bank.

The delay in land restitution was understandable, the staff representative commented. Full restitution, including documentation, took time; indeed, it might well continue into 1997 or 1998. However, the Government had introduced a bill--mentioned on page 13 of the staff report--that would speed up at least the private use of agricultural land. As Mr. Solheim had noted, the expectation was that about half of the land would be used by the private sector but would not be fully restituted in the sense that full documentation would be made available; such documentation would be needed if one were to try to sell the land.

The authorities certainly intended to increase the volume of G-24 funds to be channeled to the banking sector if they judged that the banking sector could handle the flow, the staff representative stated. That matter would be carefully examined during the reviews under the new stand-by arrangement.

If adhered to, the programmed monetary policy was expected to exert some upward pressure on the exchange rate, the staff representative commented. Indeed, in recent weeks there had been upward pressure, but the understanding was that the authorities would smooth the upward movement through intervention in the market without having a fixed point in mind for the exchange rate. The authorities felt that, at its present level, the exchange rate was still undervalued.

It was true that the staff had not elaborated much in the present report on the introduction of the new currency, the staff representative said. That was because the actual currency reform had taken place when the talonas was introduced as the legal tender, in October 1992. Hence, the introduction of the litas had been accomplished simply through an exchange of one currency--that was considered temporary--for a new one, with a factor 1 to 100. The staff planned to complete fairly soon a short article--possibly for the IMF Survey--on the experience with the introduction of national currencies in all three Baltic countries, the Kyrgyz Republic, and some other countries.

The question had been raised whether, with the reduction of unemployment benefits, there might be a disincentive for enterprises to restructure and release unneeded labor, the staff representative commented. There had been a hardening of the budget constraint in the program in the sense that the bankruptcy procedures were supposed to be in place by the end of 1993. Some hardening of the budget constraint on enterprises could be spurred by initial bankruptcies, which would of course put pressure on remaining enterprises. It was useful to note that there had been not only a reduction in unemployment benefits--for high-income persons, not those with low incomes--but also plans for a shift toward a more active labor market policy through increased training of released labor.

Of course, only time would tell whether the shift to indirect controls in the area of monetary policy had been made too soon, the staff representative commented. However, there was a safety valve in that area, in the sense that the staff was watching the situation carefully, and there was a more or less double target on the monetary side: the performance criterion on net domestic assets of the central bank, and the indicative limit on the growth of reserve money, which, if adhered to, would put the brake on domestic credit expansion by the banking sector.

The situation with respect to the interenterprise arrears had not actually worsened in recent months, the staff representative remarked. Although those arrears were still equal to about two thirds of the money supply in August 1993, the volume at midyear had been even larger; hence, at least there had been some improvement in the situation. Nevertheless, the arrears were still undoubtedly a problem. The implementation of the bankruptcy law should help to harden the budget constraint. As was noted in the staff report, the monetary part of the program did not permit arrears to be settled through bank credit expansion. The implementation of the bankruptcy law was still being worked on.

It had been noted that Russia planned to make interenterprise debt marketable, the staff representative continued. That technique could be useful in dealing with debt, but it would work only if there was a willingness to harden the budget constraint on enterprises by allowing bankruptcies and closures in appropriate cases.

As to the bunching in the future of Lithuania's liabilities to the Fund, the staff could not comment at the present stage on the total level of the Fund's exposure in the country, because the level of access under the extended Fund facility (EFF) for the coming period had not yet been determined. However, one of the main advantages of the use of the STF and then the EFF was the avoidance of an early bunching of repurchases through longer maturities.

The ratios of revenue and spending to GDP were currently lower than initially estimated, the staff representative commented. The main statistical reason for that development was that nominal GDP estimates were now significantly higher than before, and revenue and spending estimates had not risen by as much. In substantive terms, the lower ratios underscored the urgent need to strengthen tax administration, and in particular to bring the newly emerging and growing private sector within the tax net. Technical assistance in that area was being provided by EC PHARE and the Fund.

There were two reasons why Lithuania's electricity export prices had not reached world market levels, the staff representative from the European II Department said. First, there was a minimum quantity of electricity generation that had to be produced to make it economically viable at the margin, and that amount would be in excess of Lithuania's need. Second, the grid was such that the export possibilities were limited; for instance, Belarus and the Kaliningrad region--major electricity importers--had both been unwilling for the time being to pay the full world market price, and some arrears had arisen as well.

Mr. Dorrington said that he wondered whether it was correct to conclude that a significant improvement in the interenterprise arrears situation in the coming year or so was unlikely. Finally, while the recommended use of the STF and the EFF, as well as the stand-by arrangements, would avoid an early bunching of repurchases, he hoped that that would not be at the cost of a late bunching of repurchases.

The staff representative from the European II Department responded that the arrears situation had begun to improve, but not dramatically. Significant improvement would have to wait until early 1994, although, of course, that was not far away. Finally, avoiding late bunching would be one of the considerations in determining the level of access for Lithuania under the EFF.

Mr. Posthumus recalled that on a previous occasion the staff had mentioned that the authorities might move to a pegged exchange rate. He wondered what advice the staff would give the authorities now in the area of exchange rate policy.

The staff representative from the European II Department said that the staff still believed that it was somewhat too early to fix the exchange rate. However, the authorities should try to smooth the movement in the rate. At present, the authorities were intervening in the market to smooth the upward movement but not to stem it completely.

Mr. Wei made the following statement:

> The Lithuanian authorities indeed deserve commendation for their successful implementation of the adjustment program supported by the previous Fund stand-by arrangement. The preliminary foundations for developing a market-based economy have been laid. In this context, I agree with the staff's assessment that, if the program on today's agenda is fully implemented, Lithuania's transformation process toward a market-based economy will be accelerated.
>
> Continued fiscal prudence will no doubt be helpful for stabilizing the economy and moving Lithuania toward a noninflationary growth path in the medium term. To reduce the fiscal deficit and ultimately stop the Government's dissaving will require efforts on both the revenue and expenditure sides.
>
> However, from the staff report, we note that "general government" has been used instead of "central government" to define the fiscal deficit criteria. I am not sure about the wisdom of using the general government deficit as a performance criterion for the envisaged program. As we know, Lithuania is undergoing tremendous political, economic, and social changes, as is the administrative structure within the Government. In addition, the statistical framework is far from developed. All these factors make it difficult to develop reliable consolidated government accounts. It would be appreciated if the staff could brief us on the rationale for doing so.

On government expenditure, I support the authorities' intention to establish expenditure priorities rather than have across-the-board expenditure cuts. Expenditure cuts are surely vital for achieving the deficit reduction target. But across-the-board cuts might be counterproductive. To mitigate the negative effects on economic activity, establish the physical foundations for long-term economic development, and protect the hard-hit elements in the society, an overhaul should be conducted to rationalize the expenditure structure and prioritize the necessary spending, with the aim of helping to reduce the budget deficit, on the one hand, and shielding the economy from unnecessary shocks on the other.

Financial sector reform is urgently needed. The banking system must be modernized, but I do not believe privatization of state-owned banks is the best solution to this end.

Conventional wisdom tells us that banks are not like other enterprises, given their unique role in the financial sector and in the economy at large. Low efficiency and/or loss-making in the banking sector should not be entirely blamed on ownership. In my view, these failings are the outcome of government interference with day-to-day operations. As entrepreneurship has not evolved well during the transformation from a centrally planned economy to a market-based one, competition in the banking sector may not be rational. Severe competition as a result of privatization, together with a lack of well-established institutions with supervisory responsibility, might lead to a disorderly situation in the banking system, which is the last thing we want to see. In this sense, I would recommend that at the present stage state-owned banks be restructured so that they have autonomy with regard to daily operations. Only when the banking sector has become more mature and the necessary supervisory mechanisms have been put in place should we consider privatizing them gradually. Without these necessary conditions, privatization will be risky.

These observations do not mean that I do not support privatization in the rest of the economy. But the privatization process should be accompanied by nurturing the securities market's development and establishing a well-targeted social safety net.

Finally, I would encourage the staff to help the authorities in expeditiously developing a comprehensive statistical framework by incorporating the burgeoning private sector. According to the staff report, private sector activity may now account for 10-15 percent of the total. If such a magnitude of activity cannot be realistically reflected, it will discount the accuracy of our analysis and the usefulness of our policy recommendations. As is stated in Mr. Solheim's very helpful statement, "the official national account figures may overestimate the fall in production, as they do not fully capture activities in the growing private sector." In this connection, having recognized the staff's tremendous efforts in helping Lithuania in the statistical area, I would like to invite the staff to redouble their endeavors in this respect.

Before concluding, I have a question on which I would like the staff to shed some light. Owing to their relations with the rest of the former Soviet Union, Lithuania relies too heavily on imported energy to keep its economy going. It is self-evident that the current terms of trade deterioration has hit the economy hard. Without dramatic changes in the economic structure in the foreseeable future, dependence on imported energy will make the economy much more vulnerable to external shocks. Lack of mechanisms to cushion such shocks will have a serious impact on the economy. Against this backdrop, I would appreciate it if the staff could tell us in which areas they recommend fundamental structural changes in order for Lithuania to enjoy its comparative advantages, so that the economy will be less vulnerable to external shocks.

In closing, I would note that the authorities have accomplished much in adjusting their economy. However, much remains to be done. Like other speakers, we believe that, with the successful implementation of the policy reforms contained in the program, the Lithuanian economy is expected to move onto a healthy growth path. Needless to say, continuous financial assistance from the international community, including the Fund, will contribute to this process. With these remarks, I support the proposed decisions.

Mr. Tetangco made the following statement:

I join other speakers in commending the Lithuanian authorities for their remarkable efforts toward macroeconomic stabilization and structural reform. Their efforts are indeed nothing short of courageous, considering the extraordinary circumstances in which adjustment measures have to be implemented. Their determination has already shown important results in terms of taming the rate of inflation and firming the exchange rate of the national currency.

Maintenance of the authorities' prudent financial policies and strengthening of structural reform should generate rich dividends for Lithuania in the future. As the staff notes in the appraisal, the current situation presents an opportunity that must be seized to establish the right conditions for renewed economic growth.

I believe that the proposed program contains elements that implemented in combination should help achieve the objective of restarting growth under stable conditions. This is not to say, however, that the task ahead is going to be easy, as there are significant problems that remain to be addressed.

The staff and previous speakers have dwelt on the important issues thoroughly, and I agree with most of what has been mentioned. I only have a couple of comments.

The first is that progress on the inflation front will need to be firmly established. The acceleration of price inflation in September might have reflected seasonal and other special factors, although the staff believes that this was also triggered by a significant real depreciation against the ruble, owing mainly to higher inflation in Russia. This suggests that a stable real exchange rate is important in holding down inflation, and raises the question as to whether financial policies were fully consistent with lowering the rate of inflation. With respect to international competitiveness, a depreciation does not seem to be called for. As Mr. Solheim points out in his statement, the competitive position of the industrial sector remains satisfactory, considering the initial undervaluation of the litas. Perhaps the staff can elaborate on this issue and comment on the expectation with respect to exchange rate movements under the proposed program.

My second comment is that stabilization needs to be pursued at both the macroeconomic and microeconomic levels. At the macroeconomic level, the authorities have been successful in limiting the growth of domestic credits. At the microeconomic level, there is clearly room for reducing enterprise arrears, which the staff estimates to be about two thirds of broad money as of end-July 1993.

Netting out and settling arrears is undoubtedly a complicated operation. While such an operation can be expected to take time, it is important that, in the meantime, new arrears not be allowed to accumulate.

As in other economies in transition, efforts in Lithuania to document, net out, and settle existing arrears require accompanying measures designed to cultivate financial discipline in state enterprises. In this connection, I welcome the plan to fully implement the Bankruptcy Law by the end of 1993 and to utilize market-economy accounting standards by the end of the program period. This should help prevent a further buildup of arrears and subject state enterprises to hard-budget constraints. Furthermore, operation of such entities on a commercial basis should enhance prospects for their privatization.

The settlement of tax arrears should clearly provide some flexibility on the fiscal side. I would appreciate staff comment on whether information on the level of tax arrears is available and, if so, the extent by which the Government's financial position would improve if such arrears were settled.

Based on the experience over the past year, one is justified in expecting that the Lithuanian authorities will continue to work toward further improvement of the economy. As many speakers have commented, a great deal remains to be done, vigilance will be required, and Lithuania will continue to need the support of the international community.

I fully agree with these comments, and, with respect to the request before us today, I would like to reiterate what I said during the previous Board meeting on Lithuania, namely, that Lithuania can be helped by further collaboration with the Fund and deserves the continued assistance of this institution.

Ms. Laframboise made the following statement:

To echo the opening statements of other speakers, we are impressed with the substantial strides taken by the Lithuanian Government to stabilize the economy and advance structural reforms. The authorities are to be commended for their perseverance in this regard in the face of the hardships caused by such rapid adjustment. In view of the commitment demonstrated by the authorities and the impressive results obtained to date, we support the request for a stand-by arrangement and a purchase under the STF.

While we agree with the staff appraisal, we would like to comment on some aspects of the program that, in our eyes, require some elaboration. With respect to monetary policy, we also share the concerns expressed by Mr. Desruelle about whether the move to manage credit through indirect controls rather than direct controls may be slightly premature. We must be sure that the sophistication of the financial system is sufficiently advanced so that the use of indirect controls provides adequate control of credit. As the staff has already responded on this issue, we would just like to suggest that particular caution be exercised in the implementation of this aspect of the program in order to ensure a continued appropriate monetary policy.

With regard to the labor market, the imposition of strict budget constraints on enterprises--which must be enforced--is likely to result in an end to labor hoarding and disguised unemployment. Accordingly, we question the staff's projection for unemployment of only 7 percent in 1994. The experience in other economies in transition, together with the recent large decline in real output in Lithuania, suggest that unemployment is liable to rise considerably above the 7 percent predicted. In light of the Government's intention to enhance unemployment relief, this could impede the authorities' ability to achieve the financial deficit target of 1 percent of GDP.

Indeed, the document stipulates in several instances, as does Mr. Solheim's opening statement, a target for the general government financial deficit of no more than 1 percent of GDP in 1994. We would like to note, however, that the fiscal deficit, or the Government's borrowing requirement, will be equivalent to 5 percent of GDP, as indicated in Table 6 on page 24. While this would appear to be stating the obvious, we would not want to foster the illusion that a financial deficit of 1 percent of GDP creates a liability on economic resources of only 1 percent of GDP.

The authorities noted that the Government now expects to play a more active role in the disbursement of foreign funds with the assistance of the State Liabilities Commission. Disbursing external resources on a timely basis is crucial to improving the supply response of the economy by expanding its productive capacity. However, allocating resources efficiently is of equal importance, and we share the view of Mr. Posthumus on administrative investment decisions; we are not convinced that the best allocation of resources would materialize by way of government intervention. Notwithstanding the technical assistance to be provided in this domain, when governments of any stripe are responsible for allocating investment resources, they are often exposed to significant, and sometimes irresistible, political pressures. We would urge the authorities and staff to ensure that these funds are not used to finance current expenditures, and that commercial viability criteria are applied to all decisions on investment projects.

On the subject of government committees, we note that the authorities have established an Agency on Prices and Competition, which has limited powers to freeze prices and the authority to recommend that enterprises with a dominant share in a sector be broken up. Could the staff tell us what authority this agency holds, and on what basis it makes judgments on appropriate pricing? We are, of course, concerned that arbitrary judgments on price and industrial structure could introduce distortions into the economic system.

The external outlook in the medium-term forecasts includes six years of uninterrupted improvement from 1994 on, after a current account deficit of 8.3 percent of GDP in 1994. We would suggest that this forecast is quite optimistic, and we would like to have seen an alternative scenario from the staff in order to get a better picture of the possible external financing requirements under a "worst-case" scenario.

Notwithstanding these comments, we would like to take this opportunity to commend the authorities for their courage and tenacity in undertaking the necessary and painful steps in the transition to a market economy.

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

Lithuania is one of the few countries of the former Soviet Union that has achieved remarkable progress in its economic reform program. Indeed, from the staff report it is clear that, despite the difficult and constraining conditions in which they have had to operate, the authorities have successfully completed the first adjustment program supported by a stand-by arrangement. The authorities are to be commended for their adherence to the objectives of the program and for achieving a certain amount of macroeconomic stability, while introducing measures that are creating a strong base for the development of a market economy. The success achieved so far is also indicative of two very important factors: first, the strong determination of the authorities to implement the reform measures; and, second, the quality of the program.

Turning to the present program, for which the Lithuanian authorities are requesting Fund support, we are pleased to note that it appropriately continues to build on previous achievements in the different sectors of the economy, and we agree with the measures envisaged as well as with the objectives set. We share the views of previous speakers on the necessity for the authorities to pursue fiscal consolidation and to ensure macroeconomic stability through prudent fiscal and monetary policies as well as continued efforts to restructure the budget and the financial system. Regarding the latter, we note that the difficulties encountered by the authorities in monitoring and enforcing prudential requirements could reduce the effectiveness of monetary and credit policies. Like others, we agree that delays in the reform of the financial system are a major cause of these problems. We would therefore join others in recommending to the authorities that they accelerate their efforts regarding banking reforms.

Structural reform measures, especially those regarding the public enterprises and the agricultural system, continue to receive full attention in the program, as indeed they should. A deepening of reforms in these sectors can only speed up the process of adjustment to a market economy. However, on land privatization, particularly agricultural land, we note that the process is taking more time than expected. Could the staff comment on the reasons for the delays?

As regards foreign loans, the more active role that the Government is playing will certainly help to ensure that disbursements are made on time and thus help to alleviate the shortfalls in foreign exchange. However, care needs to be taken to see that these are used for productive investments, and that net lending to the Government is kept at a prudent level, so as not to breach any performance criteria. Here again, progress in reforming the banking system will help to improve the allocation of resources.

Overall, we agree that the successful implementation of the measures envisaged under the present program will create a solid foundation for future adjustments, in the context of a medium-term program. We broadly share the staff's analysis and recommendations and support the proposed decision.

Mr. Cserés made the following statement:

I join previous speakers in commending the Lithuanian authorities for their determined and so far successful efforts to conclude the first Fund-supported adjustment program in a difficult external environment marked by great economic and political uncertainties. It is important for the authorities to preserve the momentum of the adjustment in order to safeguard all they have accomplished until now.

As I broadly agree with the staff's appraisal, I will focus my remarks today on the issue of financing Lithuania's sharply deteriorating external position. Lithuania's uncertain prospects for attracting foreign direct investments introduce a large unknown into the forecast of Lithuania's financing needs. It will be very difficult, and will take much longer, for Lithuania to restructure and modernize its domestic industrial base and penetrate Western markets without a significant infusion of outside capital into the economy. On the other hand, the small Lithuanian economy would be very responsive to even moderate inflows of foreign direct investment, and the supply effects would be stronger and faster than elsewhere in the region owing to the rapidly developing institutional framework.

The three Baltic states are competing for foreign capital not only with Central and East European countries which have had a somewhat longer and more successful experience with market systems, but also with each other. At present, the regulation of foreign investments in Lithuania is very liberal. However, next year's expiration of the generous tax exemption for investors and the economic policy consequences of recent political changes (e.g., the expected changes in the privatization process and the expansion of the social safety net accompanying a more gradual reform) might discourage foreign investors. Would the staff care to comment on its forecast that the 1994 balance of payments will show a 50 percent increase in foreign directed inflows?

Although Lithuania has no major foreign debt, maintaining external solvency will not be easy from now on. Private sector lending has been negligible up to now, and most of Lithuania's new money has come from the international financial institutions and state-to-state agreements. Because the 1994 current account deficit target is unprecedentedly large, it is essential that there be no delays in providing promised financial support. During the previous program, the promised foreign assistance was disbursed more slowly than expected, which unnecessarily increased the cost of the transition. I therefore urge the Fund to use all its influence with the donor countries to avert a repetition of these problems during the present program.

Lithuania's banking sector still faces significant structural problems. Financial sector reform is essential to the recovery of investment and must continue to bear a high priority. We know that valuable initiatives are under way to strengthen banking supervision and improve the functioning of the banking sector. Nonetheless, the staff report notes that some banks are still unable to perform even the basic banking functions. This raises concerns about whether the forthcoming foreign assistance will be effectively allocated, as the banking system cannot yet be relied on and there is equal doubt about the ability of any government body to do better. As the experience of other transition countries shows that the cost of recapitalizing and restructuring the banking sector can be very high, I would be interested to know what financial resources are earmarked for this purpose in the program's 1994 budget.

The program before us clearly demonstrates the intention of the authorities to transform their planned economy into a market economy. Lithuania's situation is still very difficult and will require both private and official financial assistance for years to come. We therefore fully support both of Lithuania's present requests.

Mr. Dlamini made the following statement:

Satisfactory performance by Lithuania under the previous stand-by arrangement aptly demonstrates the authorities' strong commitment to their transition program to a market economy.

Devastated by a steep economic decline, a sharp terms of trade loss, and an intractable inflation problem in 1992, the authorities established disciplined financial policies and sustained structural reform as the hallmark of their economic management. Notably, the tightening of fiscal, monetary, and incomes policies was duly complemented by structural reform efforts that included the liberalization of prices and the trade and exchange rate regimes. Also, appreciable progress was made in the privatization area. These efforts have contributed substantially to improved economic performance during the second half of 1993, as the rate of real GDP contraction slowed, the inflation rate decelerated rapidly, and the external sector position strengthened. The prospects for stronger recovery in 1994 are bright if current adjustment efforts are sustained.

It is against this background that we consider the new arrangement as providing an opportunity for continuity of program implementation and a chance to build on past gains from adjustment. In particular, the new program seeks to achieve high and sustainable growth in a stable macroeconomic environment as well as enhanced efficiency in resource mobilization and allocation. We welcome the authorities' policy strategy to achieve these goals, as articulated in their memorandum of economic policies, and we hope that their implementation will be sustained, and that additional measures will be taken as may be necessary to keep the program on track. As I am in broad agreement with staff appraisal and policy recommendations, I will limit my comments to a number of broad issues.

I recognize that the maintenance of disciplined financial policies is crucial to the overall success of economic transition in Lithuania. In this regard, the restrained stance of fiscal and monetary policies is a step in the right direction and should be continued. The urgent need for an accelerated pace of structural reform, particularly the establishment of institutional structures and manpower development for operating a market economy, should also be underlined. In this context, the banking system reform should be accorded much higher priority than what the current program has provided for. The establishment of a strong banking system would enhance the allocative efficiency of the economy and reduce the role of the Government, through its State Liabilities Commission, in external loan disbursement to only broad policy issues.

Experience elsewhere shows that deep government involvement in domestic credit operations lacks merit. Generally, there is a lack of necessary expertise for such operations, and political considerations often compromise monetary objectives and complicate the task of the central bank. It would be beneficial if the authorities accorded greater priority to the privatization of the banking sector, in which active foreign participation would be allowed. This would facilitate the injection into the sector of foreign capital as well as the required technical and manpower needs.

We commend the authorities for their commitment to the liberalization of interest rates and the abandonment of interest rate subsidies. However, given the fact that basic financial infrastructure necessary for the successful adoption of market-based instruments of monetary policy is still rudimentary, and given the uncertainties of using reserve money as an indicative target for liquidity control--as rightly pointed out by Mr. Solheim in his statement--I wonder why the quantitative ceiling on domestic financial assets growth is restricted to the Bank of Lithuania. I feel that such a limitation could impair the effectiveness of monetary policy. The apparent lifting of direct control of aggregate bank credit expansion at this stage seems to be premature. I would welcome the staff's comments.

Finally, while supporting the proposed decision, I urge the international community, including the Fund and the World Bank, to sustain their financial and technical support for Lithuania. Such assistance would become more meaningful if it were backed up by increased market access for Lithuania's export commodities in the West.

Mr. Link made the following statement:

I am pleased to note that, despite the difficult circumstances, Lithuania is making considerable progress in the transformation of its economy. Like other Directors, I would like to commend the Lithuanian authorities for having met all the quantitative performance criteria for the 1992-93 program, and for the successful introduction of a national currency. Wage discipline, fiscal discipline, and inflation reduction have been impressive. In light of Lithuania's strong economic policies, I would like to express my support for the request for a new stand-by arrangement and the initial purchase under the STF in support of its economic stabilization and reform program.

I would like to make some comments and raise a few questions. On the fiscal side, I welcome the decision of the Lithuanian authorities to raise the effective rate of excise duties on petroleum products, and I would like to commend them for eliminating the majority of energy subsidies. This will strengthen the budgetary position.

In turn, I could not find any staff comment on the progress made on measures to be taken to enforce tax collection and penalize delinquent taxpayers, which were briefly mentioned in the memorandum of economic policies. Discussing negative GNP growth, both the staff and the Lithuanian authorities mention that official figures do not capture some private sector activity. I think it would be correct to say that Lithuania--like other countries in transition--is facing serious problems in the area of tax collection from such activity. Thus, I would like to ask the staff what concrete steps are being taken to resolve this problem.

Turning to structural reforms, I would be interested in receiving more details from the staff on the privatization strategy. In particular, to what extent does the state intend to maintain stakes in the enterprises to be privatized? What are its medium- and long-term strategies in this respect?

Another problem is the interenterprise arrears. As it was raised by previous speakers--and I agree with their views--I will not repeat the questions that were raised about this matter.

I would like to ask a couple of specific questions regarding the social safety net. The staff reports that "pensions are low," and that a bill "providing for a more fundamental restructuring of the pension law is being prepared." It is also mentioned that a new subsistence minimum, to which social benefits will be linked, will be applied in 1994. I would be interested in knowing if pensions and unemployment benefits will also be linked to a subsistence minimum. The staff mentions that unemployment benefits will be related to the minimum wage. Does the minimum wage cover the subsistence minimum? What is the mechanism envisaged for protecting pensions and unemployment benefits against inflation?

Having made these remarks, I would like once more to praise the Lithuanian authorities for their achievements in building the framework of a market-oriented system in the economy, and I wish them well in the implementation of a tight transformation program.

Mr. Al-Tuwaijri made the following statement:

Let me start by joining previous speakers in commending the Lithuanian authorities for their impressive effort to transform their economy into a market-based one. Industrial output has leveled off, inflation continues to decline, and a tight incomes policy is helping the economy to adjust to the terms of trade shock from higher energy prices. However, as the authorities are well aware, much remains to be accomplished. The ongoing financial and technical support of the international community, if utilized in a productive way, should help in establishing a credible basis for the growth of the Lithuanian economy.

I will not repeat the comments made by previous speakers, but I concur with some of them, especially with regard to the strengthening of the financial sector, the continuation of a prudent fiscal policy, the importance of speedy implementation of the bankruptcy law, and the concern about the slow process of privatizing agricultural land.

I would like to emphasize one point regarding opening markets and access to products. The staff mentioned in the paper--and rightly so--one important element that will contribute to the success of the authorities' efforts, which is basically the ability of the country to change the direction of trade. In the case of Lithuania, certainly the free-trade agreement with some European countries will help in this effort.

However, this really confirms what we have known all along: the importance of opening markets for the products of the country in transformation. It is very important for them in order to realize their objective of transforming their economy. Here, we see a very successful case in Lithuania. This successful case of transformation depends mainly on the strong effort of the authorities, which we commend, the strong support of the international community in terms of financial and technical assistance, and the opening of the markets for Lithuanian exports.

Finally, given our experience with the successful effort of Lithuania in applying the right policies, I have no hesitation in supporting the proposed stand-by arrangement.

The staff representative from the European II Department said that the staff had chosen the General Government, rather than the Central Government, as the basis for the fiscal performance criterion under the proposed stand-by arrangement. The staff had taken the same approach for the previous stand-by arrangement with Lithuania. The General Government consisted of not only the Central Government but also the social insurance funds--which carried out a large portion of public expenditure--and the local authorities. The choice of the General Government gave the staff a better handle on total fiscal operations, because functions could easily be shifted from the Central Government to the social insurance funds or the local authorities.

A World Bank mission, with Fund staff participation, was currently in Lithuania to take a medium-term look at public expenditure, the staff representative noted. A Fiscal Affairs Department technical assistance mission was planned for November 1993 to be of further help in that area. The Fund's assistance in the future in the field of statistics would include one statistical resident representative for all three Baltic countries.

Lithuania was subject to external shocks in the area of energy price and supply, the staff representative commented. Lithuania had no indigenous energy sources; it produced energy but with imported raw materials, including oil and nuclear fuel. At present, the use of energy in the country was clearly highly inefficient and was based on very low prices. Any investment in that area would, of course, have a big payoff. The EBRD and the World

Bank were involved in the energy sector, but improvements in the situation would take time.

Lithuania's main comparative advantage was its skilled labor force and low labor costs, the staff representative commented. In that connection, shifts of resources into those areas would have a major payoff.

The staff did not yet have sufficient data to answer Mr. Tetangco's question on tax arrears, the staff representative said. The arrears problem had worsened in recent months, but not significantly. It was true, of course, that the fiscal picture would be more comfortable if the arrears could be eliminated. Strengthening the budget constraint through the implementation of the bankruptcy law could help in that area; that approach had helped Estonia to reduce its tax arrears. The hope was that, if the relevant procedures could be strengthened, the arrears problem could become manageable and remain so.

The staff would certainly keep a close watch on the effects of the introduction of indirect monetary controls, the staff representative commented. The staff was in constant touch with the authorities through the resident representative.

Whether or not the 7 percent unemployment forecast was too optimistic remained to be seen, the staff representative said. That forecast referred to open unemployment, which was currently 2 percent. Total unemployment was already greatly in excess of 7 percent.

The staff had introduced the double performance criteria--one for the financial deficit and one for net lending--to prevent the use of foreign funds to finance current government expenditure, the staff representative explained. The 5 percent total--1 percent for the financial deficit and 4 percent for net lending--made the size of directed lending look too large, because the 4 percent included World Bank and EBRD lending, which at least had the sanction of both institutions.

The main function of the pricing authority was to survey developments, the staff representative noted. However, it was empowered to freeze prices temporarily when it considered that a monopoly position had been utilized. Its enforcement powers did not extend beyond that situation.

The projected 50 percent increase in inflows of foreign direct investment in 1994 did not seem overoptimistic, the staff representative considered. The level was still not very high. Although Estonia's economy was much smaller than Lithuania's, the inflow in Estonia had been larger in nominal terms than the inflow predicted for Lithuania in 1994. One of the main reasons why the staff expected a significant increase for Lithuania was the more stable economic environment that was anticipated.

The staff could not say for certain what the cost of financial restructuring was likely to be, the staff representative said. Considerable work still needed to be done in that area before the cost could be accurately estimated. The World Bank was working on that area; it was considering making a loan for the purpose of helping to restructure the financial sector.

The authorities' plans in the area of tax administration were outlined in paragraph 12 of the memorandum of economic policies, the staff representative noted. The EC PHARE, as well as the Fund, was providing technical assistance to improve tax administration, which was clearly a priority area of technical assistance.

Progress on privatization had been significant, even in comparison with the progress in Lithuania's two Baltic neighbors, the staff representative said. Progress on land restitution had been slow, but progress on the actual use of agricultural land by private users had been accelerated.

As to the social safety net, it was true that, at present, the pension system was a flat-rate system, the staff representative from the European II Department commented. With technical assistance, particularly from the World Bank rather than the Fund, the intention was to move over the medium term toward a system that linked pensions more closely with contributions. Meanwhile, unemployment benefits were to be linked to the minimum wage rather than to previous earnings. That step would, of course, mean a reduction of benefits for persons whose earnings exceeded the minimum wage. The minimum wage, or the pension base, would be adjusted from time to time, but the adjustment would not be automatic; a discretionary decision by the Government would be required.

Mr. Solheim made the following concluding statement:

> First, I want to thank Directors for their many useful and interesting comments and suggestions. My Lithuanian authorities attach major importance to the views expressed by Directors at the Board meetings, and they will be duly informed about today's discussion. While I note that all Directors have, overall, supported the proposed program, some concerns have been expressed about, e.g., the swift shift to an indirect stance of monetary policies and the early abolishment of incomes policies. Some difference of opinion also seem to exist as to the pace of privatization in the financial sector.
>
> Several Directors have argued that the staff has not dealt sufficiently with some of the issues. I agree that the staff paper is a very compact one, but I understand that this is in accordance with the existing guidelines for program papers. Moreover, the staff representative has dealt comprehensively with the many questions posed by Directors, thus throwing more light on the many interesting issues raised during the discussion. I will, in view of the staff representative's comprehensive response, limit my concluding remarks to a few issues.

Many Directors have expressed concern about Lithuania's current and prospective inflation performance. Let me only state that to combat inflation is one of the Government's major policy objectives. My authorities--supported by the staff as well as by some of the Directors--consider the inflation target for end-1994 as realistic.

As to the stance of fiscal policy, I may add that, so far, my authorities have largely applied across-the-board expenditure restraints in maintaining budgetary balance. Although this is an effective way of cutting expenditure, it is not a desirable procedure to follow over a longer period of time. In the future, my authorities will, to a greater extent, aim at a more efficient use of government funds. Technical assistance is therefore being provided to the Ministry of Economics to establish procedures to select the most efficient public investment projects. For this purpose, a special Public Investment Unit has been established.

Many Directors voiced concern about the authorities' temporarily more active role in the disbursement of EC/G-24 loans than had originally been envisaged. I would like to underscore that this is a second-best solution, and that my authorities intend to channel significantly larger sums through the banking system next year.

Many Directors have touched on trade questions. I would only like to add that cooperation among the Baltic countries is widening in a number of areas, including the trade field.

Most of the Directors expressed concern about the somewhat uncertain situation in the financial sector. I agree that this is a sector that has to be given high priority. In accordance with this, Lithuania will receive substantial technical assistance in this area in the time ahead. My authorities concur that much more has to be done in such areas as the prudential regulation and restructuring of the financial sector.

I have not much to add to the many relevant comments on the foreign exchange rate policy. As I stated in my opening statement, this is, for the time being, one of the most politically sensitive issues. Despite the fact that Lithuania appears to have a competitive edge relative to Estonia and Latvia, the strengthening of the litas has evoked more criticism from industrialists in Lithuania than in the neighboring countries. This may, to some extent, be explained by Lithuania's higher trade share with Russia, as well as with other countries of the former Soviet Union. As a result, the effects of the appreciation of the litas against the ruble, except the recent months' real depreciation, has been more marked in Lithuania. Moreover, operational problems have also existed in the commercial banks' actual fixing of exchange rates, but these are in the process of being solved through the recent opening of the new interbank exchange.

Although privatization has progressed faster in Lithuania than in most other countries under transition--including the other Baltic countries--a lot remains to be done, not least restitution of land. While the privatization of agricultural land is being implemented without final settlement of the ownership question, the restitution problem is delaying, or even halting, the privatization process in other sectors. In addition to the legal and other factors outlined by the staff representative as contributing to the delays in privatization, another problem is that more land is being claimed than is available. The restitution question is also a difficult political issue, and strong and differing views are prevailing in all the Baltic countries. However, it is encouraging that recently a number of large firms have been privatized with foreign participation. In fact, in the first nine months of 1993, foreign direct investment from Western countries was twice as high as in 1992 as a whole. This should gradually have a significant impact on the transfer of technological know-how and, ultimately, on Lithuania's foreign trade flows.

All in all, Lithuania has gone through a year of massive economic adjustments and major political changes, while still keeping the program on track. In view of the considerable tasks ahead, my authorities are formulating their policies within a medium-term perspective. In this context, they have expressed interest in an EFF arrangement, and I note some speakers' encouraging comments on this question.

Even though the Board will only review the program performance semiannually, there will be at least quarterly staff visits. Continued frequent contacts between the staff and the authorities are likely to remain of importance for keeping the program on track. Moreover, my authorities are well aware that in order to achieve the program objectives, considerable technical assistance will be required in many areas.

In conclusion, I think it is appropriate to say that my authorities have now passed their undergraduate tests, and that the next program is implying that they have moved to the graduate stage. In his statement, Mr. Posthumus concluded, "The transformation process is safely on course, I hope." I want to conclude that I feel certain that Lithuania is safely on course and will continue to be one of the success cases of countries under transition.

The Executive Board approved the following decisions:

Republic of Lithuania - Stand-By Arrangement

1. The Government of Lithuania has requested a stand-by arrangement for a 17-month period in an amount equivalent to SDR 25.875 million.

2. The Fund approves the stand-by arrangement set forth in EBS/93/164, Supplement 3.

Decision No. 10496-(93/146), adopted
October 22, 1993

Republic of Lithuania - Purchase Transaction - Systemic Transformation Facility

1. The Fund has received a request by the Government of Lithuania for a purchase equivalent to SDR 25.875 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993).

2. The Fund approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 10497-(93/146), adopted
October 22, 1993

2. SYRIAN ARAB REPUBLIC - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with the Syrian Arab Republic (SM/93/217, 9/29/93; and Cor. 1, 10/13/93). They also had before them a background paper on recent economic developments in the Syrian Arab Republic (SM/93/221, 10/8/93).

Mr. Shaalan made the following statement:

Over the past few years, the Syrian economy has been undergoing a transformation from a system characterized by regulations and control to one in which market forces and private initiative play an increasingly large role. The exchange system has been liberalized; the effective exchange rate has been substantially depreciated; pricing policy has become more flexible; and subsidies have been reduced. As a result, private sector activity has increased substantially. This increasing role is reflected in the sizable jump in private sector imports, which increased from 20 percent of total imports in 1988 to 65 percent in 1992. In terms of the main economic indicators, real GDP growth has been impressive over the past few years while inflation and, until recently, external pressures have largely been under control.

There is no doubt that favorable exogenous factors partly contributed to the improved performance of the economy, mainly through favorable weather conditions and initially relatively high world oil prices as well as generous external grants. The Syrian authorities recognize that the economy remains sensitive to exogenous factors. Moreover, they recognize that the reform process is still in its early stages--but they are committed to stay the course and further liberalize the economy. Owing to the vulnerability of the agricultural and oil sectors to exogenous shocks, the main policy challenge facing Syria is how to diversify the production base while at the same time containing inflation and external pressures.

Important measures have been adopted recently that should, over time, contribute to more sustainable growth, led by the private sector, and reduce the savings-investment gap. The new Investment Law (Law No. 10) was promulgated in 1991 with the objective of encouraging private investment in the agricultural, industrial, and transportation sectors. The law has already begun to bear some fruit; the projects in these sectors that have thus far been approved by the Higher Council of Investment are equal to LS 133 billion, of which the equivalent of LS 65 billion (approximately $1.3 billion) is in foreign currency terms. Admittedly, part of the investment has been in noncommodity-producing services sector, but the Government intends to take actions to further stimulate investment in the main productive sectors.

Concomitantly, and as noted above, steps have been taken to further deregularize the economy and encourage private initiative. The trade and payments system has been liberalized and restrictions on current account transactions further reduced; pricing policy has been made more flexible, as prices of most products sold by the private sector are now, in effect, free, while, in the public sector, costs are valued at the neighboring countries' exchange rates; all public trade monopolies have been, in practice, eliminated under the provisions of the Investment Law; and all private sector transactions are now effected at the rate prevailing in neighboring countries' exchange markets--which reflects market developments. These measures seem already to have increased private sector confidence, as reflected in the substantial increase in external private transfer inflows in 1992.

The authorities recognize that more needs to be done to further reduce structural rigidities. They are determined to continue with their liberalization program. Although the authorities' strategy tends to be gradualistic, it is implemented with determination. This gradualism is driven largely by the priority that is being placed on minimizing the social disruptions associated with transforming the economy from a heavily government-regulated one to an economy in which market forces play an increasingly large role. This, however, should not underestimate the progress made in this area, as a comparison of the economy today with what it was, say, in 1988 would attest. In the near term, the authorities intend to unify the exchange rate, further ease restrictions on current account transactions, and further reduce the coverage of subsidized products to only essential food items combined with appropriate targeting.

The Syrian authorities are cognizant of the fact that supportive macroeconomic policies are essential to sustain this transformation in an environment of low inflation. On the fiscal side, the budget position shifted to a deficit of 1.1 percent of GDP (including foreign grants) in 1992, compared to a surplus of 1.8 percent in 1991. It may be relevant to note, however, that developments in 1990-91 were to a degree exceptional, owing to the relatively high world price of oil, which resulted in a very high level of business profits; business profits tax revenues declined by more than 3 percent of GDP between 1991 and 1992. In 1993, the deficit is envisaged to grow to nearly 7 percent of GDP, notwithstanding the fact that current expenditure is expected to be less than 14 percent of GDP, compared with nearly 15 percent in 1992 and 17.6 percent in 1991. The envisaged widening of the budget deficit in 1993 reflects mainly the increase in development projects, particularly in the area of electricity, sewage, and water, which are partly foreign financed, and the change in the valuation of foreign loans for such expenditures. This increase in infrastructural investment is of a temporary nature and reflects much-needed investment in key sectors of the economy. The authorities view price stability as an important policy objective and are committed to taking the necessary measures to keep inflationary pressures under control. Moreover, they intend to make the price stabilization fund (PSF) fully self-financed in the near future.

The authorities recognize the importance of increasing the ratio of revenue to GDP, which is low by international standards, and of generally addressing the underlying structural weakness of the budget. Recent measures have been taken that should, over time, substantially improve revenue performance. These include: (1) the lowering of business profits taxes from the prohibitively high rate of 66 percent to a structure with a maximum rate of 45 percent to provide incentives to private sector firms and reduce tax evasion (Law No. 20); (2) the conduct of surveys to better assess the business profit liability for tax purposes; (3) the increase in stamp duties (Law No. 15); and (4) the improved efforts in the recovery of tax arrears from the past 15 years. In the period ahead, the Government intends to mobilize revenues by using the general approach of shifting the tax burden from production to consumption. The authorities are currently considering adopting a general sales tax to be initially applied at the manufacturer level in 1994; in this regard, a Fiscal Affairs Department technical assistance mission has already visited Syria, and the authorities are looking forward to its assessments and recommendations.

Turning to the external sector, the balance of payments remained in surplus for the fifth consecutive year in 1992, although the overall surplus has been declining. The decline resulted primarily from a weakening trade surplus following the disruptions of trade with Syria's traditional partners, in particular the former Soviet Union, and more recently the deterioration in the terms of trade and the increase in private sector imports. As for 1993 and the medium term, the balance of payments position is expected to be difficult and sensitive to exogenous factors, as shown by Table 3 of the staff report. The need to maintain tight financial policies and to take steps toward structural reform, including the establishment of a realistic unified exchange rate, is crucial to keeping the external position manageable--and the Syrian authorities are committed to this. They also place great weight on diversification and on redirecting trade to new markets as a means of addressing Syria's susceptibility to exogenous shocks and the disruption of exports to the traditional markets.

Moreover, the authorities wish to emphasize their commitment to avoiding recourse to borrowing at nonconcessional terms to fill the resource gap implied by Table 3, which they expect to address through increased capital flows under the Investment Law and from donor countries for investment projects. The Government maintains very strict control over the contracting of external loans in order to avoid increasing the debt burden.

Finally, on arrears to the World Bank, the Syrian authorities wish to express their commitment to settling these arrears. They stressed this to the Fund mission in August. More recently, on the occasion of the 1993 Annual Meetings, the Syrian delegation, led by the Ministers of Economy and Finance, held discussions with senior World Bank representatives to reach a final settlement. At that time, the Syrian delegation again emphasized the priority that Syria places on reaching an agreement; earlier that month, Syria resumed payments with a $12 million installment. The discussions with the World Bank are continuing, and it is hoped that the matter will be resolved in the near future.

Mr. Al-Jasser made the following statement:

The growth of the Syrian economy over the past three years has been most impressive, especially when viewed in the context of the global recession and the disruption in trade with the former Soviet Union. While this growth has been propelled by increased oil production and favorable weather conditions, the implementation of significant measures to liberalize the economy has played a major role. In particular, the introduction of Investment Law No. 10, coupled with the liberalization of the exchange and trade systems and the adoption of a more flexible pricing policy, has enhanced private sector confidence and led to a substantial rise in investments and remittances.

These commendable adjustment efforts have established a strong base to build upon. Also, the challenge facing the authorities at this time is to strengthen these efforts so as to reach the critical mass needed to put the economy on a sustainable growth path. The importance of forcefully forging ahead with adjustment is underscored by the projected sharp deterioration in the fiscal and external balances in 1993 and the medium term. In this regard, the authorities' commitment to reduce the fiscal deficits through increased revenue mobilization and rationalization of expenditures is encouraging, especially in view of the authorities' declared intention to settle their arrears to the World Bank, as noted in Mr. Shaalan's helpful statement.

On the revenue side, it will be helpful to give priority to the reduction of import duty exemptions and their rationalization along with an adjustment in the valuation rate of imports to reflect the planned unified exchange rate. Reforming and simplifying the tax codes, along with strengthening tax and customs administration, are also critical to improving revenue performance and enhancing the productivity of the tax system. In this regard, the recent increase in stamp duties and the efforts to better assess business tax liabilities are steps in the right direction. In addition, the authorities' intention to strengthen collection efforts, to explore a shift from specific tax rates to ad valorem rates, and to consider the introduction of a general sales tax in 1994 along the lines recommended by the Fiscal Affairs Department technical assistance missions, is indeed welcome.

On the expenditure side, the authorities' efforts at reducing current spending, while increasing the much-needed capital expenditure on infrastructure, especially power generation, are encouraging. In this connection, the recent measures to reduce or eliminate certain food subsidies are in the right direction.

The efficiency of the Syrian economy could also be enhanced if nonfinancial public sector enterprises were streamlined and accorded greater autonomy in setting prices and implementing employment policies, while subjecting them to hard-budget constraints. This should improve their productivity, strengthen their finances, and reduce their need for transfers from the budget. Moreover, the large borrowing requirements of these enterprises from the banking system would decline, thus facilitating financing of the essential public infrastructural projects, as well as the investments of the growing private sector.

Syria is well endowed, not only with natural resources, but also with a world-renowned entrepreneurial population. Thus, the Syrian economy has great potential for growth and expansion, especially in the area of private sector activities. To help realize this potential, the financial sector needs to be broadened and deepened. The resulting increased competition in the banking sector and the freeing of interest rates would go a long way toward mobilizing, as well as allocating efficiently, the domestic savings to finance the investments needed to put the economy on a solid growth path. However, to minimize the risk of disruptions to the financial system, a strong prudential supervisory capability should be put in place in time for that competition.

Turning to the external sector, the authorities' move toward more realistic foreign exchange pricing and their efforts at liberalizing the exchange and trade systems are welcome. However, in view of the projected sharp deterioration in the balance of payments in 1993 and in the medium term, it appears to be of particular urgency for the authorities to act on their commitment to unify the multiple exchange rates at a realistic level. Moreover, encouraging exports further through simplification of regulations would go a long way toward diversifying exports and export markets, as well as improving the balance of payments outlook. The fruit of such reforms are already obvious in the case of Syria. The data cited by Mr. Shaalan on capital inflows and investment resulting from Law No. 10 are impressive indeed.

Mr. Törnqvist made the following statement:

The Syrian Arab Republic has in recent years embarked upon the road of economic reform. The dismantling of the complex system of controls and distortions that has been the hallmark of the Syrian economy for many years is indeed a welcome development.

Nevertheless, the process appears painfully slow. In particular, it is regrettable that the opportunity provided by the relatively favorable external conditions, such as good weather, high oil prices, and relatively large foreign grants, has not been used to speed up the process.

As indicated by the long list of commodities subject to price controls that appears in Table 33 in the background paper, price controls are still quite intensive and detailed. It is doubtful that a gradual approach will work in such conditions. The removal of controls on one commodity may increase the distortion with respect to other commodities, making further liberalization imperative. In particular, the removal of price controls, in itself, will not necessarily remove economy-wide distortions significantly unless a prior unification of exchange rates has been achieved. The distortions caused by the multiple exchange rate praxis is likely to have a systemic perverse effect, even if other prices are free to move.

To achieve the long-term benefits of price liberalization, the authorities have to accept some short-term cost of adjustment. It is understandable that the authorities would like to give the economic agents time to adjust to the changes. But, the danger is that a gradual approach will increase, rather than decrease, the adjustment cost over the long term by temporarily distorting some signals even more while correcting others, thereby inducing the wrong kind of adjustment. For this reason, I am convinced that the unification of exchange rates is really the key to any credible reform.

A more liberal trade regime is also important from the perspective of increasing competition in sectors where insufficient competition is an obstacle to price reform. Could the staff comment on whether such sectors can be identified in the case of Syria?

Along with unifying exchange rates, other aspects of the exchange rate regime need to be re-examined. The praxis of pegging the Syrian pound to the U.S. dollar is, on the surface at least, difficult to understand. The United States accounts for only less than 1 percent of Syrian exports and only 6.5 percent of its imports over the period 1988 to 1992. The external competitiveness of Syrian industries is therefore forced to improve or deteriorate at the whims of a currency of a country that appears to be of only marginal importance in terms of Syria's external trade. The praxis of pegging to the U.S. dollar is particularly questionable in view of the policy objective of creating incentives for a diversification of the export base. I understand that the choice of the U.S. dollar as an anchor currency may be based on the desire to stabilize over the short run the monetary impact of fluctuations in U.S. dollar-denominated oil revenues caused by changes in the U.S. dollar exchange rate. However, I do not believe that such considerations should override the need to create a stable environment for emerging export industries. The staff's assessment of the relative merits of pegging to the U.S. dollar would be appreciated.

Second to exchange rate unification, the most important task for the Syrian authorities is fiscal reform. One is particularly struck by the vulnerability of the revenue base, as demonstrated by the sudden decline in tax revenue in 1992, caused by a plunge in the tax revenue from profits. There appear to be four major sources of instability in tax revenue: the shift in administered prices; the fluctuation in oil revenue; the variable collection efforts; and, recently, the decline in the exports to the states of the former Soviet Union. The only long-term cure for this vulnerability is to move away from profit- and trade-based sources of revenue toward consumption- and income-based sources. Currently, taxes on wages and salaries amount to only 0.7 percent of GDP and taxes on domestic goods and services 1/2 percent.

The excessive reliance on business taxes, rather than consumption and income taxes, not only contributes to the vulnerability of tax revenue to economic conditions, but also is a major obstacle to reform as well, as the removal of price controls might have unpredictable consequences for public finances. It is therefore of utmost importance to reform the tax system in order to secure a broader and more reliable revenue base. I would appreciate some further indications from the staff as to how much revenue (in terms of share of total revenue or GDP) the proposed sales tax will generate.

The recent peace initiatives in the Middle East open a new window of opportunity for countries in the region, including Syria, to divert the enormous amount of resources previously used for defense purposes to a more productive use. I strongly urge the authorities to use that opportunity to the fullest extent possible. From the available information, one can perhaps only guess the total cost. But the fact that the expenditure on defense-related wages and salaries exceeds the civilian wage and salary expenditures illustrates the potential for savings.

Mr. Al-Jasser remarked that the Syrian pound was pegged to the dollar. In principle, as the dollar had declined in recent years, Syria's exports should have become more competitive. That trend was consistent with the authorities' objective of diversifying exports. Given the limited volume of trade with the United States, the fairness issue in terms of other trading partners did not arise.

Mr. Sirat made the following statement:

I must confess that I have mixed feelings about the country case we are discussing today. It is my impression, after having read the staff report, that our discussion might be rather academic, given the large gap that seems to exist between Syria's economic situation and the readiness of the authorities to fully and expeditiously address this issue. I will therefore be extremely brief.

The economic situation may be summarized as follows. First, there is a highly expansionary policy mix, including a rapidly growing fiscal deficit--from 1.4 percent of GDP in 1990 to above 10 percent in 1993, including grants--and what the staff calls a "passive" monetary policy. Second, there has been rapid growth of activity in recent years, but it has been concentrated in the oil and agricultural sectors, while the manufacturing sector suffered from a drop in output of 24 percent in 1990-92. There has been a balance of payments surplus of approximately $500 million a year in convertible currencies since 1990, in parallel with the accumulation of sizable external arrears to a number of bilateral creditors, including my country, and the World Bank. This surplus had been maintained in the context of a sharp fall in the trade with former CMEA countries. Syria now has to find new markets and economic partners and thus has to clearly reinforce its competitiveness in non-oil sectors.

In this context, the authorities seem to favor an extreme gradualism under which the reforms so far have been limited to some liberalization of transactions. Such a policy looks quite inappropriate, as exogenous factors, which have helped postpone economic difficulties so far, are rather fragile, as exemplified by the staff's balance of payments projections showing rapidly rising current account deficits. The staff report describes all the other measures which would be contemplated in the comprehensive macroeconomic strategy, including tight demand-management and major structural reforms. I broadly share its appraisal, but, as I said earlier, I remain skeptical as regards the authorities' immediate readiness to implement such a broad strategy. If anything, more precise data should be provided by the authorities in a number of areas, including external financing. Let me just mention in this regard that Syria's external medium- and long-term debt is estimated by the authorities at $3.5 billion, while the most recent world debt tables mentioned $15 billion. Such a major discrepancy may not be considered as reassuring by the creditors as regards recognition by Syria of its external debt.

At this juncture, I would strongly urge the authorities to expeditiously solve the arrears issue as regards the World Bank and other external creditors. It is certainly a source of great concern for my authorities that so far Syria has not proved itself committed to regularizing its arrears or even stopping their growth. The authorities' decision not to normalize Syria's financial relations with its external creditors at a time when it benefited from a balance of payments surplus is extremely worrisome. Such a regularizing would indeed be a prerequisite for any possible reinforcement of Syria's financial and economic relationship with the international financial community. Given the magnitude of the potential financing gaps mentioned in the staff report, with needed capital inflows of approximately $6 billion during 1994-97, it seems that Syria would indeed need such reinforcement.

Mr. de Groote made the following statement:

As an introductory comment, let me support the staff's view that, in light of the prospective deepening economic imbalances on which Mr. Sirat has just commented, there is indeed an urgent need for the Syrian authorities to accelerate the pace of structural reform in the context of tighter demand management. In fact, the current context presents a window of opportunity for the authorities, basically for two reasons, one of a macroeconomic nature, the other one of a structural nature.

First, from a macroeconomic perspective, the cost of arresting and reversing now the prospective deteriorating trend in the public finance and external accounts is still relatively small. Too gradual a reform strategy, out of concern for minimizing the social disruptions associated with the adjustment and reform process, as noted in Mr. Shaalan's statement, could thus well prove counterproductive, as it would ultimately result in larger problems for which a solution would then require more hardship.

Second, the present situation provides a window of opportunity from the structural perspective as well. The staff paper notes, and the Syrian authorities acknowledge, that Syria needs to diversify, geographically as well as in terms of products, its external trade. With an eye on the evolving political developments in the region, it would seem appropriate to start preparing the economy right now for a period of enhanced regional trade and development. Such preparation will have to encompass exchange rate unification and liberalization of the complex exchange and trade system. And again, one can build an argument for not postponing such reforms any longer: first, as the staff has indicated, because of the current relative stability of the unofficial free market exchange rate; and second, because Syria seems to be lagging in this area compared with neighboring countries.

External liberalization, however, will need to be complemented by domestic liberalization measures, which will allow the growing private sector to fully seize emerging opportunities, and which will lead to a reversal in the trend witnessed over the past five years of negative real growth of Syria's manufacturing sector. One gets the impression that, because of the absence of a sufficiently liberalized domestic environment, the new Investment

Law has been successful mainly in attracting projects in the agricultural and transportation sectors, but far too little in the manufacturing sector. Even so, I found it hard to find an explanation why exactly the transportation sector was so successful; maybe the staff or Mr. Shaalan could provide a further explanation. I would also like to hear from Mr. Shaalan whether his Syrian authorities are contemplating any foreign involvement in the development of the domestic gas industry, which offers promising prospects as a direct or indirect foreign currency earner, but currently suffers from a lack of infrastructure and financing.

Turning to the more specific elements of Syria's liberalization strategy, let me first of all concur with the staff that a significant effort in terms of data collection will need to be made, in order for the authorities to be in a position to react swiftly to emerging macroeconomic developments resulting from the structural transformation.

One area where this will be particularly useful is the external accounts. It is rather worrying to find that the staff is unable to present a medium-term balance of payments scenario in the absence of precise information on capital flows. This is worrying for two reasons. First, Syria has an important stock of outstanding arrears to the World Bank, in excess of the central bank's level of gross foreign exchange reserves, and it thus remains unclear how the country will be able to honor its welcome commitment to settle these arrears in a timely manner. Second, agricultural and oil exports already make the country's trade and current account evolution vulnerable, necessitating external capital inflows to dampen a too large impact on a growing import demand stemming from the private sector. As the liberalization gathers pace, moreover, further unexpected current and capital account developments might occur. Keeping in mind the example of other countries in the region, it is of great use to keep track of all foreign inflows in a centralized way and to assess properly their cost and maturity structure.

The best way to insure the economy against the negative effects of an excessive reliance on external inflows is of course to enhance domestic savings, a point that I also stressed on the occasion of the Article IV consultation with Iran two days ago. The Syrian authorities are well advised to try to address as swiftly as possible the low ratio savings to GDP in the country. Part of this effort will have to correct the structural weakening of the budget. Mobilizing more tax revenues and shifting the tax burden from production to consumption are welcome steps in the right direction. Lowering unproductive expenditures and improving the profitability of the state enterprise sector will relieve the expenditure side of the budget. Another part of the savings-enhancing effort will have to deal with the private sector. Monetary policy clearly can no longer remain as passive as in the past. And financial sector liberalization, which has been lagging thus far, will need to be speeded up. In this context, I would like to hear the staff's view on the usefulness of establishing offshore banks in Syria, as is being considered by the authorities, and in particular whether the staff feels this might contribute to increasing competition in the banking sector or rather further compartmentalize Syria's financial sector.

With these remarks, I wish the Syrian authorities success in their stepped-up efforts of adjustment and reform over the coming period.

Mr. Kagalovsky made the following statement:

In recent years, Syria's overall economic performance has been quite robust. The authorities' strategy of gradual liberalization of the economy through substantial price decontrol, encouraging private investment, easing restrictions on private sector imports, and bringing the exchange rate closer to market levels, played a major role--in combination with favorable exogenous factors--in achieving real GDP growth of almost 10 percent per annum during 1990-92.

However, on the monetary and fiscal sides, Syria's performance has been clearly less successful. In the past three years, the fiscal position weakened, largely as a result of a sharp contraction in business profit tax receipts following the lowering of the tax rates. Government revenues declined from 23.8 percent of GDP in 1991 to an estimated 16 percent of GDP in 1993, whereas expenditures remained at about the same level of 25 percent of GDP. Thus, the Central Government's budget deficit (excluding foreign grants) is expected to widen this year to 8.7 percent of GDP from 1.4 percent in 1991.

The deficit, in fact, may be even larger, when taking into consideration an unaccounted for part of off-budget net consumer subsidies and losses incurred by the Price Stabilization Fund. They definitely constitute a large part of the overall fiscal deficit, and, in the future, they need to be incorporated into the budget, as suggested by the staff.

The monetary and credit policies of the Syrian authorities have remained inactive, and domestic interest rates have been largely negative in real terms for a number of years; currently they are at a level of 8 percent per annum on Syrian pound deposits held for over a year, whereas the annual inflation rate is estimated at 12 percent.

Long-term private investment in the Syrian economy is inhibited by the remaining restrictions in the trade and exchange systems, price controls, multiple exchange rates, and insufficient private financial intermediation.

In this regard, while welcoming the authorities' determination to address all these issues in the future, this chair believes that an overly gradualistic approach may prove counter-productive. I would rather agree with the staff's recommendations that a speedy liberalization of the exchange and trade system and a unification of exchange rates at a market level are fully warranted for an early strengthening of Syria's manufacturing sector and for achieving sustainable economic growth over the medium and longer term.

Among other policy measures, an early shift in taxation from production to consumption, and the introduction of the general sales tax would most certainly further Syria's goals of achieving a sustainable fiscal position.

As I share the thrust of the staff assessment of Syria's economy and support most of the policy recommendations, I would like to comment briefly on two issues that are of great concern to my authorities.

First, it is regrettable that data limitations severely constrain comprehensive analysis of Syria's prospective external developments and foreign debt situation. In fact, it seems rather unusual to come across the following statement in a staff report for an Article IV consultation with a member country (page 14 of SM/93/217): "It has not been possible to project the overall balance of payments position in the absence of precise information on external debt and policy on repaying external arrears." Mr. Shaalan's statement, unfortunately, does not provide much more information on the subject either.

Yet, given the two-fold increase in the Syrian Central Bank's gross foreign exchange reserves since 1989, my authorities share the view that Syria has the capacity to repay its external debt arrears both to multilateral and bilateral official creditors. However, the authorities' regrettably have not demonstrated so far their resolve to negotiate settlement of overdue financial obligations to foreign creditors.

In this regard, I would like to reiterate a point made in the staff report: in order to increase Syria's access to foreign capital, it is necessary that the external payments arrears be expeditiously eliminated.

Second, on a related issue, the staff correctly points out in the background paper that Syria's private sector exports to the countries of the former Soviet Union were, inter alia, aimed at settling debt amortization obligations and balances under the bilateral payments agreement. Therefore, the authorities' intention to redirect trade from the traditional export markets (namely, the states of the former Soviet Union) to new markets is, most certainly, going to further aggravate the problem of Syria's external arrears to the countries of the former Soviet Union. Accordingly, the staff's endorsement of this approach may be interpreted as support of Syria's stance of noncooperation with its largest bilateral official creditor. Although my authorities' feel that this is not the case, they believe that more caution should be exercised by the staff in its intention to back some questionable policy options.

Finally, in the context of the ongoing Middle Eastern peace negotiations and the efforts of the international community to mobilize significant economic assistance to the region, it would be useful if the staff could provide an estimate of the size of Syria's potential "peace dividend" resulting from the rationalization and normalization of regional economic ties and eventual cuts in military expenditures.

With these comments, I support the proposed decision.

Responding to the Chairman's question, Mr. Kagalovsky said that for a number of years Syria had imported goods and services from the countries of the former Soviet Union under credit arrangements. He was worried that the staff's recommendation to redirect Syrian exports from traditional markets to new areas might reduce Syria's ability to service its debt to its traditional creditors.

The Chairman commented that if the reallocation of trade was determined by the market, then, in principle, it should be optimal in terms of revenue for the country and it would therefore increase the country's debt-service capacity.

Mr. Al-Jasser commented that he supported the recommendation that Syria should diversify its exports and export markets. That recommendation should be seen as being entirely separate from one country's concern about Syria's willingness or ability to service its debt to that country. After all, one of the Fund's main objectives was to encourage a multilateral trading environment. It was unnecessary for Syria to maintain trade with the countries of the former Soviet Union in order to be certain to be able to service its debts to those countries.

Mr. Kagalovsky said that, in general, he agreed with Mr. Al-Jasser, and particularly his comments on broad diversification. However, his authorities were prepared to continue to import Syrian goods. The Syrian authorities would understandably wish to try to diversify export production and markets, but they would also gain considerably from continuing to maintain the production that met the current demand in Russia for Syrian exports.

Mr. Abbott made the following statement:

The message of this Article IV consultation report is clear. Syria has major economic problems. Most of them are self-inflicted. Basic policy corrections are needed.

The situation is quite clearly summarized on page 7, where the staff writes, "In particular, price controls, a structurally weak budget, multiple exchange rates, the restrictive exchange and trade system, and the pervasive regulation of economic activity continue to be inimical to efficient resource allocation and inhibit long-term private investment. Under the unchanged policy stance, the economic and financial position is expected to worsen in the near term."

The staff appraisal enumerates a large number of specific policy recommendations, which we can endorse in their entirety. All of the needed actions are interlinked, but we would give particular priority to exchange rate unification and maintenance of a realistic exchange value. Correcting exchange distortions will have pronounced internal and external consequences. It would introduce appropriate market incentives for correcting external imbalances and vastly reduce the need for many of the heavy-handed regulations that now suffocate economic vitality. Currency unification would also make transparent the true costs of pervasive implicit subsidies and taxes now generated through the multiple exchange rate system.

With a more transparent exchange regime, the structural weakness of the budget will become more self-evident and fiscal reforms will be unavoidable.

As it is, without the benefit of a strong oil market, the financial position of the public sector has deteriorated sharply in the past couple of years. The budget deficit this year is expected to be in the range of 7-9 percent of GDP. This needs to be corrected, in any case, if the objectives of containing inflation and fostering private-sector-led growth are to be achieved. It would be better if the necessary fiscal corrections were undertaken as part of a general structural reform, rather than being just a financial squeeze that bottled up the underlying problem.

Syria has largely isolated itself economically from the world community. We think the evidence is quite clear that Syria has benefited greatly whenever it has improved cooperation with other countries; economic assistance from the Gulf countries is the most recent example of the fruits of international cooperation. Similarly, Syria stands to benefit greatly from the prospect of peace in the Middle East. If it can implement the proper policy mix, the unfolding environment offers Syria exciting new opportunities.

To capitalize on these opportunities, the Syrian authorities need to recognize that their economy is not unique. The economy will benefit from the policy recommendations of the Fund staff, just as much as many other countries have.

Greater integration with the rest of the world will require, however, that Syria observe the accepted norms of international economic cooperation and behavior. Unfortunately, the Syrian authorities have felt they could pick and choose among the rules, especially with respect to external debt service.

As a first step, Syria should immediately clear up its arrears with the World Bank. Syria has the capacity to repay these arrears immediately and should do so.

The staff calls attention to numerous statistical deficiencies. These problems are long-standing and symptomatic of Syria's economic problems. The authorities appear to be navigating without adequate charts and instruments. These statistical problems need to be addressed as a matter of the highest priority.

The staff recommends that the Board not grant approval for the retention of Syria's exchange restrictions and multiple currency practices. We support this recommendation.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/93/145 (10/20/93) and EBM/93/146 (10/22/93).

3. NAMIBIA - REPRESENTATIVE RATE FOR NAMIBIA DOLLAR

The Fund finds, after consultation with the authorities of Namibia, that the representative exchange rate for the Namibia dollar under Rule O-2(b)(ii) against the U.S. dollar is the rate determined on the basis of the fixed relationship between the Namibia dollar and the South African rand, and the middle rate between the buying and selling rates for the U.S. dollar in terms of the South African rand as reported by the Bank of Namibia. (EBD/93/166, 10/18/93)

Decision No. 10498-(93/146) G/S, adopted October 21, 1993

4. UNITED NATIONS INFORMATION CENTRE - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the staff report for the 1993 Article IV consultation with Cyprus (SM/93/175, 8/11/93) and the statistical background paper (SM/93/181, 8/16/93) to the United Nations Information Centre, as set forth in EBD/93/167 (10/18/93).

Adopted October 21, 1993

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 93/15 through 93/17 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/93/183 (10/20/93), by an Advisor to Executive Director as set forth in EBAM/93/181, Supplement 1 (10/19/93), and by an Assistant to Executive Director as set forth in EBAM/93/182 (10/18/93) is approved.

APPROVED: March 23, 1994

JOSEPH W. LANG
Acting Secretary