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Minutes of Executive Board Meeting 94/11

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Contents

Attendance . . . . Page 1

1. Argentina - Review Under Extended Arrangement . . . . Page 3
2. Sudan - Overdue Financial Obligations - Review Following Suspension of Voting Rights . . . . Page 44
3. Zaïre - Overdue Financial Obligations - Report on Complaint with Respect to Suspension . . . . Page 60
4. Zimbabwe - Enhanced Structural Adjustment Facility - Second Annual Arrangement; Review Under Extended Arrangement; and Exchange System . . . . Page 65

Decisions Taken Since Previous Board Meeting

5. Grenada - Acceptance of Obligations of Article VIII Sections 2, 3, and 4 . . . . Page 97
6. Former Yugoslav Republic of Macedonia - Purchase Transaction - Systemic Transformation Facility . . . . Page 97
7. Approval of Minutes . . . . Page 98
8. Executive Board Travel . . . . Page 98

Executive Board Attendance

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
M.-A. Autheman	M. Sirat
	L. Fontaine, Temporary
	E. Srejber
	A. Törnqvist, Temporary
J. de Groote	A. Cserés, Temporary
	T. Isataev, Temporary
	F. Moss, Temporary
H. Fukui	S. Ishida, Temporary
	T. Kanada, Temporary
K. P. Geethakrishnan	L. E. N. Fernando
	K.-T. Hetrakul
D. Kaeser	K. Link
A. Kafka	J. C. Jaramillo
	A. V. Mozhin
	V. Y. Verjbitski, Temporary
G. Lanciotti	R. Bessone Basto, Temporary
K. Lissakers	
R. Marino	G. Torres
A. Mirakhor	
	B. S. Dlamini
	J. A. K. Munthali, Temporary
	J. Dorrington
	O. Havrylyshyn
C. V. Santos	A. R. Ismael, Temporary
S. Schoenberg	E. Wagenhoefer
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	N. L. Laframboise, Temporary
	K. J. Langdon, Temporary
E. L. Waterman	A. M. Tetangco, Jr.
Zhang M.	Wei B.
	Yang X., Temporary
A. G. Zoccali	

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant
S. W. Tenney, Assistant

Also Present

IBRD: E. S. Ghani, Eastern Africa Regional Office; F. M. King, Southern African Regional Office; P. Levy, Latin America and the Caribbean Regional Office; E. Scanteie, South Central Africa and Indian Ocean Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; A. I. Abdi, P. A. Acquah, P. Dhonte, A. M. Farah, J. T. Reitmaier, J. Santos. External Relations Department: P. M. Falcone, G. Hacche, S. Meehan. Fiscal Affairs Department: G. J. Schwartz. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; J. M. Ogoola, J. K. Oh, F. M. Zeidan. Middle Eastern Department: P. Chabrier, Director; S. H. Hitti, Deputy Director; P. Cashin, M. A. El-Erian, H. Ghesquiere, G. M. Iradian, M. D. Knight. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; P. F. Allum, R. M. Brooks, L. D. Everaert, A. K. McGuirk, A. Singh, E. van der Mensbrugghe, J. F. van Houten. Research Department: C. A. Vegh. Secretary's Department: J. W. Lang, Deputy Secretary; R. S. Franklin, A. Mountford. Treasurer's Department: D. Williams, Treasurer; L. Aylward, J. E. Blalock, W. J. Byrne, J. C. Corr, Z. Farhadian-Lorie, K. M. Kenney. Western Hemisphere Department: S. T. Beza, Counsellor and Director; K. Gerhaeusser, J. P. Guzman, M. E. Hardy, A. S. Linde, S. Paris-Horvitz. Office of the Managing Director: G. R. Saunders. Advisors to Executive Directors: J. M. Abbott, G. M. Blome, A. Chang Fong, S. K. Fayyad, T. K. Gaspard, J. M. Jones, N. Mancebo, M. F. Melhem, P. A. Merino, R. Meron, J. Ortiz Vely, Y. Patel, R. Rainford, A. Raza, J. R. Suárez, N. Toé. Assistants to Executive Directors: S. Al-Huseini, R. N. A. Ally, S. Arifin, T. Berrihun, J. M. Burdiel, A. Cathcart, J. A. Costa, D. Desruelle, M. Dzervite, S. S. Farid, C. Gaseltine, H. Golriz, M. Giulimondi, G. H. Huisman, C. Imashev, E. Kouprianova, W. C. Keller, A. M. Koulizade, T.-M. Kudiwu, V. Kural, J. Mafararikwa, G. J. Matthews, S. C. McDougall, S. del C. Olgiati, J. Pesola, H. Petana, C. F. Pillath, S. Rouai, M. Ryan, T. Sitorus, A. Viirg, R. von Kleist, Wang X., J. B. Wire.

1. ARGENTINA - REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered a staff paper on the seventh review and third-year program under the extended arrangement with Argentina approved on March 31, 1992 (EBS/94/6, 1/19/94).

Mr. Zoccali made the following statement:

Since March 1991, when the Convertibility Plan was adopted, the Executive Board has reviewed the Argentine economic program under the stand-by arrangement and its successor extended arrangement on ten occasions. During this period Argentina has re-established a successful track record in policy execution, and preliminary data indicate that the performance criteria for the quarter ended December 1993 were also observed.

My authorities view the continued support of management and staff as contributing to the successful execution of the program to date. For the future, they broadly share the thrust of the staff appraisal and are confident that full convergence of inflation and interest rates with those of industrial countries is now well within reach.

Ambitious goals and a pragmatic "results-oriented" policy mix from the outset have also translated into unprecedented gains in growth. The third year of the arrangement, based on continuing fiscal consolidation and tackling pending structural rigidities, should maintain these trends. However, sustaining high-quality growth in an increasingly competitive global environment leaves little room for complacency and confronts the authorities with two basic challenges: to foster further increases in domestic savings and to advance competitiveness through cost reductions at the microeconomic level.

The success of the noninflationary growth strategy is in great measure attributable to the elimination of deep-rooted distortions in resource allocation, while maintaining fiscal balance. Consistent with this approach, the emphasis of my authorities for 1994 centers on implementation of the social security reform and the fiscal pact with the provinces and on securing greater flexibility in the labor market.

The results of recent legislative elections in October 1993 show that the successful economic and institutional reforms put in place by the National Government to bring about stability and greater efficiency have broad political support. Some of these reforms have also been successfully executed by several provincial and municipal administrations. However, the increasing demand of the population for a major policy overhaul in many jurisdictions that have lagged behind the national administration has been evidenced by the recent episode in the northwestern province of Santiago del Estero. In order to help provincial administrations accelerate the pace of their reforms, the National Government has put together a joint program of action, known as the Pacto Fiscal, which has already been signed by 23 out of the 24 provinces. The agreement by the two major political parties on a constitutional change allowing for two successive presidential terms, and a shorter duration of four years, also paves the way for a smoother transitional period leading to the presidential elections, to take place in mid-1995.

The latest economic indicators confirm the favorable trend. Inflation as reflected in the consumer price index last year fell to 7.4 percent, the lowest level in 23 years, while wholesale prices remained flat. This occurred despite a robust real growth performance of almost 25 percent since 1991, and without price, interest rate, or exchange controls. Inflation data for November through January show an even more marked decline, with consumer prices rising by 0.2 percent and wholesale prices actually declining by 2.7 percent for this period. At the same time, the rise in unemployment to 9.3 percent is considered an unavoidable consequence of the integral restructuring of the Argentine economy, strengthening my authorities' resolve to pursue labor market flexibility with renewed vigor. It should, nonetheless, be noted that the marked increase in the labor force participation rate has tended to eclipse the fact that over 670,000 new jobs have been created since 1991, and the rate of job creation almost doubled that of population growth in this period.

Against this backdrop, three additional comments regarding the soundness of financial policies appear warranted. First, the achievement of price stability and the rapid remonetization since the adoption of the Convertibility Plan from extremely low historical levels, combined with financial liberalization and a policy of nonsterilized intervention under the currency board arrangement, have been quickly translated into significantly lower domestic credit costs. The crowding in of private sector credit demand helped to strengthen confidence and growth. This in turn facilitated fiscal consolidation, further reducing the risk premium of the economy. The terms of a recent ten-year bond issue in U.S. dollars by the privatized oil company (YPF) in the international capital market carried a coupon of 8 percent a year. The re-established availability of external credit at lower costs for an increasing number of Argentine companies is exerting pressure on local financial institutions to improve the efficiency of its intermediation. While the rapid rate of expansion of domestic lending capacity could be considered an indicator of potential systemic risk, the low initial indebtedness of private borrowers, the greater diversification of credit portfolios, and their improved quality also attenuate that risk. My authorities have nevertheless proceeded to tighten prudential banking regulations, to strengthen solvency, and to completely revamp the area of banking supervision with assistance from foreign regulatory agencies and international financial institutions, both in the design of a master plan and in the execution of on-site inspections. Further progress is to be expected in the classification and ongoing monitoring of credit and other off-balance sheet risks of financial institutions.

The second observation relates to the desirability of further increases in public savings to augment domestic savings. Since 1991, the national authorities have been able to dramatically increase revenue essentially by improving tax administration. In their view, the effort to reduce evasion has made possible the elimination during this period of over 22 distortional taxes, including taxes on exports, bank debits, and heavy fuels, and stamp duties, which, in turn, helped to broaden the tax base. While this approach entails a cost in terms of forgone revenue, amounting to some $2 billion in 1993, the effort to enhance collection by the national tax administration and customs, centered on the more neutral value-added tax and corporate and personal income taxes, boosted revenue by some $5.5 billion over 1992. With the additional gains from lower evasion in social security contributions, the net increase in tax revenue during 1993 reached almost $5.4 billion. To better appreciate the slope of the recent trend, suffice it to note that total monthly tax revenue at the beginning of the Convertibility Plan, in March 1991, amounted to some $2 billion, whereas the same indicator for January 1994 yielded over $4.2 billion, a 110 percent increase, outpacing nominal growth of the economy and staff revenue projections for this period.

The fiscal pact with the provinces builds on this successful strategy of inducing adjustment while fostering gains in competitiveness, considered crucial by my authorities for sustaining growth and long-term external viability. The agreement basically aims at rooting out distortional taxation that adversely affects competitiveness and employment creation. The National Government's undertaking to lower the high social security contributions paid by employers is contingent on the provinces' pari passu elimination of turnover taxes, stamp duties, and energy taxes and their substitution by a sales tax. In addition, the provinces will be committed to advancing deregulation and privatization and to adopting the statutory reforms that have been enacted at the national level. When the individual provincial social security systems that have contributed to financial imbalances are finally abolished, their residual obligations will then pass to the national budget. The shift from production- to consumption-based provincial taxes nevertheless impacts on firms' cost structures from the beginning and is expected to generate additional private savings on a permanent basis.

My authorities remain committed to avoiding a slackening of public sector savings while deepening policies to liberalize the economy and reinvigorate private initiative. The fiscal pact with the provinces should be viewed as part of an integral effort of reform, which includes full implementation this year of enacted legislation revamping the national social security system and introducing private pension funds. In this context, the surplus in Argentina's fiscal accounts makes forgoing part of the projected increase in public revenue a cost-effective option to boost domestic savings.

Finally, with respect to the widening of the trade balance, it should be noted that export receipts in the first 11 months of 1993 rose by 6.5 percent vis-à-vis the same period in 1992, despite the continued weakness of external markets for commodities and the unfavorable terms of trade. In the context of the nominal exchange rate anchor, exports of manufactured goods and oil and energy products jumped by 28 percent and 24 percent, respectively. The slowing down of import growth in 1993 coincides with a marked increase in the share of capital goods and spare parts, to about 40 percent of the total, as could be expected given the complete elimination of tariffs on capital goods. In sum, the availability of external financing and the creation of investment opportunities will continue to be the main determinants of the trade balance in the near future. As new projects by private domestic and foreign investors are formalized, such as the one announced this week to produce copper and gold in the northwestern part of the country, imports should remain high, with exports also picking up over time. In that example a $580 million initial investment is projected to generate annual exports of $500 million. From this perspective, my authorities consider that the medium-term balance of payments outlook contained in the staff paper is not unduly optimistic.

Mr. Havrylyshyn made the following statement:

Argentina faces a critical moment in its strategy toward the creation of a sustainable economic situation. So far, this strategy, largely built on the maintenance of a fixed exchange rate, has led in a relatively short period of time to a commendable performance with respect to inflation, growth, and capital inflows. In particular, the latter is a sign of regained confidence in the country's future.

Having said that, however, I should like to express some concerns related to several important macroeconomic policy objectives that have not been met. Three issues are troublesome.

First, average inflation--8.8 percent--is still above the target of 10.6 percent, largely owing to increases in domestic credit and financial liabilities that are far higher than expected. More important, inflation remains higher than in the United States, leading to a further real appreciation of the peso and a consequent deterioration of competitiveness.

Second, although domestic savings have indeed increased, which is most welcome in itself, the increase--1.8 percent of GDP--is half of what was aimed for in the program--3.4 percent of GDP--and they still fall short of targets and investment levels. Related to this, the current account outcome is worse than expected.

Third, we note also that unemployment has risen sharply in 1993 in the face of favorable economic growth. On the one hand, this can be taken as a sign of efficiency improvements under the strategy noted by Mr. Zoccali "to advance competitiveness through cost reductions at the microeconomic level." On the other hand, it is a development that needs careful observation so as to avoid and resist any potential pressures for renewed import protection or other governmental support for local industry. We therefore commend and encourage the Argentine authorities' resolve in their pursuit of "labor-market flexibility," as Mr. Zoccali succinctly puts it.

These three worrying developments, which have already lingered for over a year, raise the concern that Argentina may lose the momentum in the adjustment process. Next year's policy plans of the authorities, while commendable, do contain some such risks. In their approach toward the main policy issues--the reduction of inflation and the raising of domestic savings--the Argentine authorities take the position that the bulk of the growth in savings should come from the private sector through the reduction of labor costs to producers. This strategy should be pursued with vigor, but its fragility argues for a strong contingency strategy: falling back on the staff-recommended approach "to tighten fiscal policy...if the programmed improvement in private savings and reduction in the trade deficit do not materialize."

Turning to the details of the fiscal situation, the staff rightly stresses some uncertainties. These are particularly linked to the arrangement between the federal and provincial governments concerning the reform of the social security system. In addition, the reduction in some tax rates could result in a shortfall on the revenue side. Also, the strong growth in discretionary expenditures and the considerable pressure on provincial finances give reason for concern.

Under the currency board system, there is limited scope for monetary policy. Interest rates cannot be raised to reduce credit expansion and inflation. It is not so clear, however, what role monetary policy could play to address the problem of the strong growth of money supply that stems from the large capital inflows. Probably the best policy for the Central Bank would be to undertake open market operations as suggested by the staff. Sterilization of capital inflows may push interest rates up and thus attract further inflows. However, it might also induce higher domestic savings and could from that point of view be a useful policy measure.

As regards the huge capital inflows, I note that foreign direct investment, also in the staff's medium-term scenarios, remains a relatively small component of the inflows. It appears that the bulk of it consists of capital with a short-term nature. In this respect, it would be interesting if the staff could elaborate somewhat on the sustainability of these flows. What is the likelihood of a reversal of part of these flows in light of the strong recovery of the U.S. economy and the probable narrowing of the interest differential between Argentina and the United States? 1/

Finally, I agree with the staff that Argentina's credibility could be enhanced if the last two purchases of the arrangement are not made, as the authorities currently expect. A further look at their achievements with regard to the criterion for net international reserves shows a remarkable overperformance in 1992 and 1993 of 300 percent and 100 percent, respectively. In this regard, one could even argue that credibility could be further fostered if the decision were taken to abstain from all remaining purchases.

Mr. Mirakhor said that he agreed with the staff appraisal, and he wished to congratulate the authorities for the remarkable turnaround in the Argentine economy. By adopting an exchange-rate-based stabilization strategy, complemented by far-reaching reform efforts, the Argentine authorities had made substantial progress toward achieving sustainable noninflationary growth. More important, they had earned an anti-inflationary reputation and credibility. To keep that reputation and further reinforce their credibility, the authorities would have to make certain not to disappoint the expectation of private agents that real devaluation could be either avoided or, if necessary, sustained. That required the completion of the process of fiscal adjustment to enhance

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1/ A staff paper by Calvo, Leiderman and Reinhart found in March last year that half the amount of capital inflows to Latin America can be explained by the interest rate differential with respect to the United States.

monetary policy independence, as well as real adjustments to ensure flexible relative prices with the objective of improving the supply of traded goods.

While the downside risks in the authorities' strategy should not be exaggerated, there were some sources of uncertainty regarding exchange rate overvaluation, Mr. Mirakhor commented. An appreciation of the dollar, lower capital inflows, a growing trade imbalance, negative real external shocks, and a too-slow adjustment of domestic inflation could cause the emergence of serious exchange rate overvaluation. Then a strong partnership between the private sector and the Government in support of the fixed exchange rate system became crucial.

The authorities should continue their efforts to complete the fiscal adjustment, but the private sector must also be induced to do all it can to improve productivity at a pace rapid enough to strengthen competitiveness, Mr. Mirakhor observed. Moreover, both the Government and the private sector should cooperate to increase domestic savings. Mr. Zoccali's statement gave reason to believe that the authorities had that objective in mind. He supported the proposed decision.

Mr. Jaramillo made the following statement:

> Argentina continues to make significant progress in its stabilization efforts. During 1993, GDP is estimated to have increased by 5 percent while inflation was cut by more than half. The overall fiscal stance, including central bank operations, resulted in a significant surplus. Export volume grew despite continued real exchange rate appreciation, and external capital flows were sufficient to finance both the current account deficit and a sizable increase in international reserves. External debt continued its declining trend while domestic investment increased, both as shares of GDP. Prospects for 1994 indicate sustained real growth, albeit at a slightly more moderate pace than in 1993, a further decline in inflation, and continued fiscal consolidation as measured by an increase in the primary balance of the non-financial public sector. Domestic savings are estimated to strengthen sufficiently to finance a recuperation in overall investment despite a decrease in projected capital inflows. Official reserves, measured in months of imports, are expected to continue rising.
>
> For past reviews of the Argentine program, this chair expressed concern over the sustainability of the Argentine stabilization process insofar as it entailed a continued real appreciation of the local currency. We observed that although, to a certain extent, real appreciation plays an equilibrating role in the face of a fixed exchange rate and productivity growth above that of trading partners, the degree of currency appreciation in Argentina seemed to have surpassed that limit and was thus placing a burden on competitiveness.

We still have concerns regarding competitiveness, and we thus reiterate the importance of rapid inflation convergence with international levels. However, we must recognize that the results for 1993, including actions taken by the authorities to reduce enterprise costs and to enhance efficiency, which I will comment on later, may have offset some of the competitiveness losses associated with real currency appreciation as generally measured. Nevertheless, we encourage the authorities to continue to monitor carefully developments in competitiveness so as to enhance it, if needed, through whatever means may be most effective.

Sustained structural reform, particularly regarding taxation and social security but not limited to these fronts, has greatly facilitated the stabilization effort by reducing costs faced by domestic producers and by encouraging a better allocation of resources. In this respect, we believe that the revenue shortfalls induced by the unprogrammed tax reductions aimed at lowering enterprise costs, although regrettable insofar as they caused the minor nonobservance of some June and September fiscal performance targets, should not be viewed as harmful deviations from the program. By reducing costs to enterprises, they enhanced competitiveness at a modest fiscal cost, increasing the probability of the economy remaining on a sustainable track over the medium run. We thus favor waiving the observance of these criteria for June and September as suggested by staff.

We welcome the completion of the overhaul of the social security system that will enable capitalized private pension funds to begin operating this year. This reform will be enhanced by the new labor legislation that will further increase flexibility of the labor market, indirectly promoting competitiveness. In the same vein, the new revenue-sharing arrangement between provincial governments and the Federal Government is a welcome development. By inducing provincial tax reform, enhancing privatization at the local level, and eliminating certain taxes and regulations levied on enterprises, lower wage costs and a more efficient resource allocation will result, also favoring competitiveness.

Developments in provincial finances, however, continue to pose a challenge to the stabilization effort. In the past, provincial fiscal disarray was a major contributor to the overall fiscal problems faced by Argentina. In recent years, indebtedness by the provinces, and thus fiscal largesse, was checked by limiting provincial access to domestic bank credit, particularly credit extended by the provincial banks. But emerging foreign borrowing possibilities could undermine these efforts. We thus welcome the authorities' intentions to limit that source of finance to the provincial governments.

Although monetary policy is to a large extent constrained by the Convertibility Law, the authorities will continue the process of reducing reserve requirements and of equating such requirements between provincial and nonprovincial banks. Overall, an increase of 19 percent is envisaged for growth in bank credit capacity. Such a rate of growth entails a significant increase in real terms and may be on the high side, given the necessary reduction in inflation and the desired increase in private sector savings. Thus a slower pace of reserve requirement reductions could be called for, as suggested by the staff.

On the medium-term balance of payments outlook, it is noteworthy that under reasonable assumptions, despite sizable net private capital inflows of over US$8 billion a year, overall debt is expected to grow only modestly over the present decade and is projected to decline slowly thereafter. Furthermore, although potential shocks emanating from slower growth of exports, higher than envisaged growth of imports, or higher external interest rates would obviously worsen the medium-term scenarios, the observed deterioration does not seem dramatic, even if it were sustained over several years. These developments are encouraging because they indicate that the overall thrust of the authorities' policies is yielding robust and sustainable results. Nevertheless, it will be important for medium-term sustainability to secure a stronger rise in exports, and the authorities should stand ready to tighten fiscal and monetary policies if the external current account widened further.

Mr. Torres made the following statement:

On the occasion of the previous Article IV consultation with Argentina (EBM/93/99, 7/14/93), this Executive Board largely commended the authorities for their remarkable success in stabilizing the economy and recovering growth after many years of stagnation and very high inflation. Today, seven months later, the economy is heading in the same direction; since July, almost all macroeconomic variables have improved and some important structural reforms have been undertaken or are in progress. Economic growth has moved to more sustainable levels, and the inflation rate is coming down to the levels of the industrial countries. On this front, it is encouraging to learn from Mr. Zoccali that from November 1993 through January 1994, the consumer price index rose only 0.2 percent and wholesale prices even declined. Being in general agreement with the thrust of the staff report, I will limit my comments to a few specific areas.

Regarding the exchange regime, I am less concerned today than I was six months ago about the appreciation of the peso. Although appreciation increased in 1993 by a further 4 percent, bringing total appreciation to 28 percent since the peg to the U.S. dollar, in fact the rate of appreciation has been declining rapidly in line with the slowing down of domestic inflation. Also, the import boom has tapered off and exports have increased lately; nevertheless, it has to be acknowledged that there is still a significant deficit in the external current account that has been covered by capital inflows that continue to be strong. Some of these capital inflows are motivated by interest rate differentials that should decline as domestic inflation also declines. If everything continues to go well, this should happen relatively soon. Therefore, there is a need, first, to increase domestic savings, as Mr. Zoccali acknowledges; second, to enhance competitiveness; and third, to continue to improve conditions for foreign investment, so that a larger part of capital inflows are directed to productive investment.

With regard to domestic savings, and despite the staff's suggestion, it becomes clear from the staff report that the main source of increase will have to be the private sector. The "fiscal pact" will put significant pressure on central administration finances, making it difficult to increase public savings. In this context, the need to implement rapidly some of the most important planned structural reforms is particularly urgent. Especially important will be the modifications to wage-related social contributions and other labor market reforms.

Obviously, to place the main responsibility for increasing domestic savings on the shoulders of the private sector cannot be understood as a waiver of fiscal discipline. There is no question about the role played by fiscal discipline in the success of economic reform; without it, the Convertibility Law would have been a total failure. But now, the fiscal consolidation process is entering a new stage in which the Administration is dealing with what can be called federal fiscal consolidation. In the new scenario, there are many more actors than in the past, and the extent of fiscal support that the provinces may need from the Central Government is not completely known. In this regard, I agree with the staff's recommendation that the authorities need to be ready to tighten monetary policy if the new responsibilities derived from the fiscal pact become more difficult than expected.

On the monetary front I welcome the new regulations issued in 1993 to tighten capital-adequacy standards and to limit lending to borrowers that are linked to financial institutions. These new regulations are particularly important now in view of the rapid growth of private credit. The speed with which the authorities create and implement the new financial regulations must keep pace with the rate of growth of private credit.

Finally, I agree with the authorities and the staff that it would be an important signal of Argentina's progress under its present economic reform program if the last two purchases of the arrangement are not made. The Argentine authorities should be commended again for the continued success of their economic program, and the proposed decision should be approved.

Mrs. Lissakers made the following statement:

When Argentina was discussed by the Board in July 1993, this chair expressed a strong concern that, all of Argentina's accomplishments notwithstanding, there was a growing risk that the dollar peg was gradually eroding external competitiveness and that this was potentially undermining the continued success of Argentine reforms. Internal inflation was retreating, but it was still not falling fast enough to ensure the credibility of the fixed-rate peso convertibility. Export growth was stunted, imports were strong with a high concentration of consumer goods, capital inflows were surging, the money supply was expanding, and nontradable goods' prices were advancing even if tradable goods' prices were held in check by the dollar link.

Now that a full year's data are available, however, it looks like Argentina achieved a lot more internal and external convergence during 1993 than had seemed likely earlier in the year. Consumer inflation, which at midyear had seemed stuck in the high single-digit range, fell toward 4 percent by the end of the year. Wholesale prices were unchanged. The trade balance did not contract much, but the composition of trade shifted. Exports showed they were competitive enough to gather a little momentum while imports were increasingly concentrated in capital goods. The current account deficit of US$8.3 billion mirrored a rising trend of internal investment. By the end of 1993, it was far easier than it had been at the end of 1992 to view the surge in foreign capital inflows as the counterpart of rising internal capital accumulation.

The pattern of aggregate demand also looked more balanced by the end of 1993. Total demand growth moderated, but it was still able to rise 5 percent, with more of the expansion this year coming from investment and less from consumption. The fiscal position was further improved and domestic savings expanded somewhat. Job growth continued, although not quite fast enough to absorb the higher participation rates that have recently emerged. All in all, this is quite a remarkable record of success.

While the risk of deteriorating competitiveness has been greatly reduced, we continue to be concerned that Argentina is establishing convergence with international prices--a price level that leaves Argentine costs relatively high. Chart 2 (EBS/94/6) shows that the real exchange rate has returned to about the level it had been in 1980, just prior to the debt crisis. While that information is a little ominous, this level of the real exchange rate is not, per se, inappropriate. Real exchange rate indices across such a long and turbulent period are subject to a wide margin of error.

The capital flows coming in now look more securely based than did those of the pre-debt-crisis period. And, at 3 percent of GDP, the current account deficit is not overly large for a country with strong growth prospects. Still, given the central role played by the exchange peg in Argentina's overall economic strategy, further real appreciation would be highly risky. We are pleased to see that the program for 1994 gives priority to measures that will enhance external competitiveness. This will be particularly important in carrying the large inflow of private and short-term capital and holding it there. There is a certain vulnerability in this reliance on short-term private capital, at these exchange rates, and we should at least note the potential exchange risk to domestic borrowers who are taking on these foreign currency obligations.

The intention to reduce payroll taxes seems particularly well designed to meet concerns about external competitiveness. Social contribution rates are quite high, so some rebalancing of the tax burden would be appropriate in any case. The potential wage-cost reductions in certain sectors are quite substantial. Furthermore, the lower payroll charges do not seem to undermine the fiscal effort as the primary fiscal surplus is expected to increase fractionally. The other proposed labor market liberalizations should contribute toward the desired improvement in productivity.

Until now, reform and restructuring have been undertaken primarily at the federal level. We are delighted that progress is now being made in extending these reforms to the provincial level, as this has been a problematic area. The broad bargain calls for the Federal Government to pick up responsibility for provincial social security systems in exchange for modifications of federal-provincial revenue-sharing formulas and reforms of provincial tax arrangements. As the Federal Government has implemented major reforms of its social security programs, this seems to be a bargain that is both creative and sound. The staff report questions the authorities' estimates of the net revenue effects of these reforms. I would be interested in any additional thoughts the staff has on the risks these reforms pose for the Argentine fiscal program at the federal level.

Similarly, the staff has some cautionary comments about how monetary policy should be managed in 1994. The authorities plan to continue to reduce bank reserve requirements. On its own, this is a desirable policy as marginal reserve requirements are high enough to be a significant distortion to financial intermediation.

But the lower reserve requirements will allow a monetary easing that may be inappropriate. We agree with the staff that the authorities should keep a close eye on money and credit growth and be prepared to slow down the reduction of reserve requirements or to sterilize capital inflows if necessary to keep the monetary stance on an even keel. We also hope that the Argentine authorities take seriously the admonition in the staff report concerning continued progress and improvement in the regulation of the financial services sector and strengthening of bank management.

Argentina has made outstanding progress in the three years since it introduced its Convertibility Law. This program would be the last under Argentina's extended arrangement with the Fund. The authorities say that if current trends continue, they would not expect to make the last two drawings under the latest arrangement. The program proposed for this year certainly qualifies it for approval as part of an extended arrangement. If, in effect, this last annual program should form part of a classic stand-by arrangement, we would consider that just another feather in the authorities' cap. Either way, we are happy to support today's decision.

Mr. Lanciotti made the following statement:

I welcome the successful implementation of the second annual program under the extended arrangement with Argentina. Notwithstanding some minor deviations from certain fiscal performance criteria, considerable further progress was achieved in 1993 in strengthening public finances, liberalizing the economy, regularizing the country's relations with its creditors, and reestablishing the conditions for sustainable growth.

Market confidence remained strong concerning both the economy's potential and the authorities' ability to turn their solid policy commitment into concrete action. As a result, there was a further reduction of inflation--now well within single digits--and a reduction of the current account deficit at a time of strongly rising investment. A most important signal was transmitted by the fact that national savings recovered by almost 2 percentage points of GDP. Although this increase is well below the objective set in the program, as Mr. Havrylyshyn points out, it bodes well for the period ahead. This will be the period to consolidate the progress already achieved in reducing Argentina's dependence on foreign capital and proceeding along the path of sustainable capital investment and growth.

With respect to the 1994 program, I am in broad agreement with the staff's assessment. The program is correctly oriented. The achievement of its macroeconomic objectives could avoid some of the inherent risks if it was possible to generate higher savings in the public sector along the lines of the staff's original proposal, namely, over 1 percent of GDP, excluding privatization receipts. This chair, however, can fully understand the delicate political balance that sometimes needs to be weighed in order to ensure the broadest possible consensus for the continuation of strong consolidation efforts. There are instances when consensus can be as important as the particular numerical targets of a program, provided, of course, that the program's targets are close enough to what would be the optimum. In this case, I believe they are. However, the acid test will again be provided by the markets.

This means that there is no room left for even small deviations from the envisaged fiscal targets. The availability of contingency plans, as a buffer against unexpected fiscal developments, could facilitate an early reaction, if needed, should the fiscal or other key macroeconomic targets not materialize on time.

Particular risks to the budget stem from the substantial tax reforms aimed at improving competitiveness and the profitability of the enterprise sector. These reforms are welcome in themselves and could indeed contribute to lowering tax evasion. Nevertheless, there is always the question about how soon a drive against tax evasion can result in substantial budgetary gains.

Also, while the authorities' strategy for boosting private savings has merit, the saving behavior of the private sector will crucially depend on the ability of the public sector to remain, in the medium term, on the path of savings improvement. In this regard, Mr. Zoccali rightly reminds us that the fiscal pact with the provinces is to be viewed as part of the reform. This improvement, in fact, has been a key element behind the success so far of the overall strategy to boost private saving. Without the major strides already achieved in strengthening the financial performance of the public sector, private agents surely would not have displayed enough confidence to save and invest more.

As the staff commented during the Board's Article IV consultation discussion of Argentina in July, one could argue that the decline in private savings that has been recorded since 1990 may simply be the result of a leveling down of precautionary saving by private agents in reaction to much-improved inflationary expectations. If, by now, the process of leveling down of precautionary saving has approached completion, total private savings could be expected henceforth to grow faster than GDP on the condition that confidence in price stability and fiscal consolidation remains strong.

Fiscal uncertainties also seem to stem from the interrelations among various levels of government. While it is understandable that provincial finances will be under considerable pressure in 1994, the authorities would be well advised to take action to prevent excessive domestic or external borrowing by the provinces and to persuade them to undertake much-needed reforms.

On monetary policy and structural reforms, I am in accord with the recommendations of the staff. I will only reiterate the view expressed by this chair during the discussion in July concerning the inappropriateness of reducing reserve requirements at this juncture. I understand, of course, the limits and challenges placed upon monetary policy in Argentina. Much lies in the framework of the given exchange rate regime which, so far, has generally served its purpose well. Nevertheless, I wonder whether there are signs that the pace of the economy's monetization would be less strong in 1994 than in recent years. The directly related question is then whether the envisaged 14 percent broad money expansion in 1994 would be compatible with a rate of domestic inflation targeted to converge further toward the international rate.

With these comments, which are meant only as constructive criticism of a program that is well designed in the framework of the current arrangement, I support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

I commend the Argentine authorities for maintaining the momentum of their adjustment effort since the last review. As a result, remarkable progress continues to be made on the economic front. Public finances have been strengthened further, economic growth has continued at a robust rate, and the inflation rate has been reduced to 7.4 percent. The authorities' commitment to press ahead with the adjustment effort in 1994, as evidenced by their economic program, is also welcome. The emphasis on a further reduction in the inflation rate to about 4.5 percent is indeed appropriate, especially given the fixed exchange rate arrangement. Thus, I have no difficulty in agreeing to the requested waiver and supporting the proposed decision.

Fiscal consolidation will continue, and rightly so, to play a central role in the authorities' medium-term strategy. In this connection, I fully agree with the authorities that there is considerable scope for reducing tax evasion and enhancing the efficiency of tax collections. The important reform of the social security system and the proposed widening of tax coverage should also enhance revenues. These efforts notwithstanding, it remains uncertain whether the authorities would be able to achieve the projections for revenues envisaged in the program, especially in view of the reduction in contribution and tax rates. Therefore, the revenue situation should be monitored closely and additional measures should be implemented, if needed, to stem any shortfall. These could include, as this chair noted during the previous review, a reduction in some of the tax breaks that were introduced last May, particularly those relating to excise taxes on luxury goods, and increases in consumption taxes. This will not only facilitate achievement of the revenue target, but can also reduce consumption and its related credit demands. On the expenditure side, a scaling back of subsidies will also strengthen the fiscal position while reducing distortions in the economy.

While realization of the fiscal target is crucial to the achievement of the inflation goal, improving provincial finances and mobilizing private savings are also integral parts of the authorities' program. In this regard, the efforts to consolidate provincial finances, as well as the structural and tax reforms planned for 1994, are indeed important. Moreover, labor reform aimed at enhancing flexibility in the labor market is especially welcome. The positive impact of such reform on competitiveness, efficiency, and inflation cannot be overstated.

Achieving the inflation target for 1994 may also be complicated by large capital inflows and rapid bank credit expansion. Thus, in addition to improved fiscal performance, a tight monetary policy may be called for in this case. In this regard, the staff rightly notes that if inflation fails to decline as programmed, the Central Bank should delay the planned reductions in reserve requirements. Indeed, despite some efficiency losses, imposition of marginal reserve requirements may be the preferred avenue in this instance. The welcome tightening of prudential banking regulations and strengthened banking supervision should also reduce credit expansion, as well as improve the quality of the banking sector portfolio.

Turning to the external sector, the current exchange regime has served the economy well. While the real effective exchange rate appreciated markedly over the past three years, productivity gains and structural reforms have limited the negative impact on competitiveness. Indeed, as noted by Mr. Zoccali, export receipts rose by 6.5 percent in the first 11 months of 1993 despite the continued weakness of export markets and unfavorable terms of trade. Moreover, if fully achieved, the targeted convergence of inflation and the additional reforms envisaged should have a positive effect on competitiveness in 1994 and the medium term.

Mr. Autheman made the following statement:

I welcome the significant success achieved so far by Argentina, and I commend the authorities for their determination and persistence in implementing the program. The two main macroeconomic pillars of this program are the establishment of sound public finances--and this objective has now been reached with a budget surplus--and the monetary exchange arrangements set forth in the Convertibility Law. There is, I believe, no discussion of altering these two fundamental policy tenets, whatever may be their short-term inconvenience.

The main issue facing the authorities is how to strengthen further the macroeconomic credibility of the program. Or, to put it in other words, how to sustain the parity peg that has proved so useful while enhancing the productive capacity of the economy. I understand from the staff report and Mr. Zoccali's statement that the authorities and the staff agree that this will necessitate further increases in domestic savings. I share this view. But there seems to be differences of opinion on the best methods to achieve that increase in domestic savings. The staff stresses higher savings in the public sector, and the authorities insist on higher savings in the private sector through structural measures. At the present time, I am inclined to favor the authorities' approach for a variety of reasons.

There does not appear to be any immediate danger of a crisis of confidence, either in the authorities' overall economic strategy or specifically in the peg: foreign exchange reserves are significant; and the decline in the interest rate differential between loans denominated in pesos and loans denominated in dollars, down to 0.75 percent if my information is correct, reflects increased internal and external confidence. Therefore, a strategy that relies on measures to induce higher private savings rather than on direct increases in public savings is a strategy that may take a little longer to show effects and may require time to work.

The saving-investment balance is a cause of concern, given its mirror image, the current account deficit, which, at 3.2 percent of GDP, certainly deserves attention. However, it should not be a source of immediate excessive concern. It has been in the past linked to the consumption boom that usually occurs immediately after the implementation of a stabilization program based on an exchange rate peg. But the growth of import volume has come down to a normal trend. And more important, the figures in Table 1 (EBS/94/6) show that gross domestic investment in the private sector has risen from 12.6 percent of GDP to 18.7 percent of GDP, while private sector gross consumption slightly increased to 78.7 percent of GDP.

Obviously, therefore, the problem in Argentina is not the lack of growth of investment. It is a fact that the growth of investment has outpaced the growth of domestic savings. However, recent structural reforms, such as privatization, have created large portfolio opportunities that could sustain private capital inflows for some years. The fact that Argentine residents still hold a large amount of financial resources abroad might facilitate, as long as confidence in the economic program is maintained, the mobilization of foreign funds in favor of investments in Argentina. In this regard, the maintenance of the present peg seems to me critical, whatever difficulties may arise in the conduct of short-term monetary policy, because I think that repatriation of Argentina's past capital outflows will rely on it.

The structural measures the authorities are trying to put in place, such as a reduction in employers' social security contributions, the elimination or reform of inefficient provincial taxes, and the reform of the labor market, could be quite effective in further boosting productivity, profitability, and then savings by the business sector.

On competitiveness, I wonder whether the figures we have been provided are not misleading, and I would like to comment on the price structure and on unit labor costs. First, if my information is correct, the evolution of prices of internationally tradable goods and of domestic protected goods, such as housing, health, and education, has been quite divergent. As producer prices for internationally tradable goods were stable in 1992-93, this would call for a more positive assessment of Argentina's competitiveness than would the mere appearance of consumer prices. Second, for a measurement of the real exchange rate of the Argentina peso, we should not rely on the consumer price deflator but should pay attention to unit labor costs. I have no recent figures, but according to the statistical appendix to the background paper circulated in July (SM/93/137, 7/1/93), industrial wages declined steadily in real terms in 1989, 1990, 1991, 1992, and presumably in 1993, while productivity growth was strong. Therefore, I would guess that in order to capture the real exchange rate of the peso, we should look not only at the consumer price deflator but at the unit labor cost deflator. This being said, I fully support the proposed decision.

Mr. Zhang made the following statement:

The year 1993 marked the second consecutive year of notable success in the country's macroeconomic stabilization and adjustment program, supported by the Fund's extended arrangement. It is particularly noteworthy that inflation came down steadily to about 7 percent in 1993. Meanwhile, economic growth has been sustained. Like many other countries in the region, Argentina has continued to attract large capital inflows to support higher domestic investment and growth. These commendable achievements are attributable to the authorities' persistent pursuit of sound macroeconomic policies and economic reform. I can go along with the staff appraisal and the views expressed by previous speakers, and thus I will confine myself to some aspects of the 1994 program.

The reduced contribution rates will improve resource allocation, enhance enterprises' competitiveness and savings, promote employment, and create conditions for a reduction in tax evasion. However, we are concerned about an adverse impact on revenue. Moreover, we are not convinced that maintaining varying contribution rates among the provinces, as stated in the authorities' letter of December 22, 1993, would be conducive to heightening competition, since it is desirable to have one unified rate for the sake of simplification, efficiency, and fairness. Could the staff shed some light on the advantages of this measure that the authorities intend to implement. In my view, this step may result in discretionary tax treatment, thus promoting unfair competition.

Given Argentina's reliance on private capital inflows, both now and in the period ahead, and in view of the programmed reduction in the inflation rate from 7.4 percent to 4.5 percent, it is crucial that the authorities maintain a prudent monetary policy stance. In this connection, it is encouraging to learn from Mr. Zoccali that the authorities have "proceeded to tighten prudential banking regulations to strengthen solvency, and to completely revamp the area of banking supervision." On the issue of gauging the appropriateness of the current average reserve requirement, there is no doubt that a reduction is justified in the sense that it can improve the overall efficiency of the banking system by reducing the cost of maintaining a higher level of reserves. However, I would echo the staff view that the planned reductions should be delayed because they would hinder the containment of the inflation target. In this regard, I also note that the authorities intend to continue the policy of gradually raising reserve requirements with a view to achieving policy uniformity. We encourage and welcome this policy stance.

This inevitably leads me to the issue of private capital inflows and the actions needed to sterilize their destabilizing effects. Capital inflows have persisted in Argentina, induced mainly by continued interest rate differentials and improved domestic economic policies. However, their adverse, destabilizing bearing on macroeconomic management, in terms of fueling persistent inflation and compelling real appreciation of the currency, should be of concern. In this context, the program for 1994 is well targeted, with top priority being given to raising domestic savings, the deep-seated source of Argentina's continued reliance on capital inflows. In any case, due attention needs to be given to sterilizing the surge of inflows. Therefore, I would once again stress the need to raise the reserve ratio. It is also essential that the authorities institute, as early as possible, open market operations that would facilitate limiting the influence of capital inflows on the money supply.

Significant structural reforms in recent years have enabled the authorities to produce sustained growth and improve markedly the external position. Nevertheless, deepening and accelerating structural reforms could greatly strengthen the effectiveness of domestic and external policies. While encouraged by the remarkable headway in reforming the tax system and implementing a revenue-sharing system to deal with weakened provincial finances, we also note with satisfaction that several of the most-needed reforms are planned. In particular, increasing labor market flexibility and instituting bankruptcy laws would be helpful in improving domestic economic activity and enhancing external competitiveness and, thus, merit our support.

If the hard-won gains to curb inflation, improve efficiency, and achieve sustained growth can be further augmented in the 1994 program, and substantial progress can be made in addressing existing obstacles toward a sound economic growth path, it is likely that Argentina will be able to re-enter the international financial market and graduate from the use of Fund resources at an earlier stage. With these remarks, I support the proposed decision.

Mr. Schoenberg made the following statement:

Because this Board discussed the successful reform program of Argentina extensively only seven months ago, and because I take it from the staff report that Argentina continues to make progress in consolidating the program and its sustainability in the second year under the extended arrangement with the Fund, I can be brief. I will comment only on those aspects that could constitute a risk to the further successful attainment of the program's objectives. In fact, my concerns are similar to those raised by Mr. Havrylyshyn and other speakers. They relate particularly to the sustainability of capital inflows on the present scale.

The staff notes that Argentina's GDP was boosted to a considerable extent by sizable private capital inflows. The staff's analysis, however, suggests that the time might have come for Argentina to reduce its dependence on capital inflows by raising national savings. I agree with the general thrust of that analysis and the staff's recommendation on how to achieve that objective. Either national savings have to be increased today to finance national investment or such savings have to be made tomorrow to deal with the debt and debt service following continuing strong capital inflows. An increase in domestic savings would also lower the vulnerability of the balance of payments to external shocks.

In any case, like other speakers, I would welcome some comments by the staff on the sustainability of the present high level of capital inflows into Argentina and their relationship to an "optimal debt cycle" for the country. Obviously, much depends on the analysis of the sources of the capital inflows--for instance, the question of to what extent such inflows are just the reversal of earlier outflows--and on the domestic use of the external resources. However, the fact that the inflation rate is still in the double-digit range and that there is little scope for monetary policy to reduce inflation under the currency board system points to the need to raise national savings while reducing the dependence on foreign capital.

Present circumstances warrant caution by the Central Bank in planning reductions in reserve requirements; it should take appropriate measures to sterilize capital inflows. I am less concerned than are other Directors about the exchange rate. At least insofar as the capital inflows prove sustainable, there is a need for a mechanism to consolidate the new balance of payments structure--namely, the corresponding current account deficits--and to engineer the terms of trade gains--namely, the welfare gains--which usually follow sizable capital inflows.

On fiscal policy, I would like to stress the staff observation that in the context of a fixed exchange rate and an open capital account, the burden of restraining domestic demand falls mainly on fiscal policy. In this connection, the steps to reform the social security system could be a mixed blessing. The intended remolding of the pension system from a pay-as-you-go system to a capitalized system and the government takeover of the provincial social security systems pose a considerable risk for the budget, particularly in the form of revenue shortfalls. As a consequence, the staff rightly urges the authorities to stand ready to tighten fiscal policy by slowing the growth of public spending or increasing revenues.

Also, it is my impression that several fiscal measures outlined in the program are somewhat ambiguous. For instance, despite tax reductions in order to lower production costs and to strengthen private savings, public sector revenues are expected to increase by 1/2 of 1 percentage point of GDP. We hope that the projected increase in revenues resulting from the removal of tax deductions and the reduced evasion of social security contributions will in fact materialize in 1994. The staff report is also somewhat vague on the reduction of public expenditures. One element of lower public expenditures would be, according to the staff, reduced public investment. Given Argentina's need for public investment, I wonder whether such a reduction is the best strategy or whether the Government should rather reduce other categories of public spending.

I support the proposed decision and hope that the Argentine authorities will find it possible not to make use of further drawings under the existing program. I also hope that the successful economic development in Argentina thus far will serve as encouragement and an example to its large neighbors to the north.

The staff representative from the Western Hemisphere Department said that very little new information was available on the net revenue effects of the fiscal reforms. Tax collection figures for January did not yet reflect rate reductions. Total revenue was 16 percent higher than that in January 1993. Because the program estimated a 12 percent increase for the year as whole, the January figure was not worrying, but it did not show a large margin either.

Within the revenue structure, much of the uncertainty concerned the extent of progress that could be made in reducing evasion of social security tax collections, the staff representative continued. There was significant scope for improvement, although the fact that social security collections had increased by 26 percent suggested that efficiency was already being enhanced. The evolution of revenue would have to be watched carefully as the year progressed.

The sustainability of capital inflows, particularly in the medium term, presented a difficult area of judgment, the staff representative commented. The inflows of capital could, to a large extent, reflect the return of Argentine capital that had fled the country in the 1980s. But a large amount of capital was still being held abroad; for example, the latest figures on bank deposits showed about $15 billion of Argentine capital deposited in banks abroad. That capital could be expected to return over time as confidence improved and opportunities increased in Argentina.

Also, as Mr. Autheman had mentioned, strong portfolio opportunities existed in Argentina, the staff representative added. The staff's projections for direct investment in the medium-term outlook might be on the conservative side, and it should not be forgotten that there still remained a large amount of assets suitable for privatization.

As mentioned in the staff report, difficulties with the statistics might conspire to give a false impression of the amount of gross inflows, the staff representative said. In Argentina, it was not possible at present to distinguish among transactions in foreign-currency-denominated debt between transactions by residents and by nonresidents. For example, the majority of holdings of External Bonds, which arose from the forced conversion of bank deposits, were probably in the hands of residents. When the Central Bank amortized those loans, the resources in effect stayed within the country. In the balance of payments statistics, however, they appeared as an improvement in net international resources offset by private capital inflows. To some extent, the same held true for public sector debt service denominated in foreign currency. As a result, gross inflows were perhaps overstated by about $1 billion a year. That money was in effect being recycled and thus perhaps exaggerated the perception of the need to mobilize large capital inflows.

Over the medium term, according to the staff's projections, the overall debt ratios, including private sector debt, were not particularly worrisome in relation to GDP at about 29 percent, the staff representative commented. However, in relation to exports, debt service was quite large. Thus this kind of debt was still a problem in terms of potential liquidity issues.

The comments by Mr. Autheman about the competitiveness indicators were well taken and should be taken into account, the staff representative said. Certainly, using the consumer price deflator might be somewhat misleading, especially as the increase in consumer prices mainly reflected the continued rise in prices of nontradable goods. Perhaps the merit of the series was that it was consistent over a long period of time, and therefore threw some light on the level of competitiveness in the long run. While it might be more useful to have a series of unit labor costs, data were unreliable; the staff would try to develop information in that area further in future Article IV consultation discussions. More definitive evidence would be given by the behavior of exports: if they showed more dynamism, the medium-term sustainability of the program would be that much more reassured.

Finally, the staff agreed with Mr. Zhang's remarks on the difference in reductions in social security contributions by sector and by province, the staff representative from the Western Hemisphere Department noted. The differential could create distortions and administrative difficulties. But the authorities' strategy was to begin to reduce the burden of high social security contributions with the tradable goods sectors, so as to improve competitiveness. The reductions in contributions at that point would affect about 30 percent of the labor force. The intention was eventually, so long as fiscal conditions permitted, to extend those reductions more uniformly across sectors and to simplify administration.

Mr. Shaalan made the following statement:

> As most Directors have already remarked, the authorities have been implementing a far-reaching stabilization and structural reform program, and the results of their efforts are impressive to date. The inflation rate has been reduced from levels approximating hyperinflation to single digits in a relatively short period of time; public finances have turned around from sizable deficits to overall surpluses; major structural reform measures have been implemented; and, at the same time, economic growth has been robust. Since the previous review, economic performance continues to be on track, and I support the proposed decision.

Moreover, the authorities' commitment to continue with these reforms, particularly in the area of social security reform and in labor market flexibility, as noted by Mr. Zoccali, augurs well for sustaining high-quality growth.

As I am in broad agreement with the staff's assessment, I will touch very briefly on certain aspects of the program for emphasis. The successful implementation of reform policies has promoted strong inflows of capital from abroad, which have given rise to short-term policy challenges that are all too familiar to this Board. The authorities are to be commended for the manner in which they have absorbed these inflows. The marked decline in the rate of inflation, the recent slowdown in the appreciation of the real effective exchange rate, and the performance of the export sector are a testament to the appropriateness of the policies implemented to address the flow of capital. The continued fiscal consolidation envisaged in 1994 should further strengthen these trends.

Beyond this, I would just add that if improvements in private savings or tax administration do not materialize, then the authorities may wish to consider sterilization as the staff suggests. Here I note with interest Mr. Havrylyshyn's statement that sterilization may have a beneficial side effect, namely, an increase in private savings by presumably raising interest rates. That may be true. What is definitely likely to happen is an increase in budgetary debt-service payments, thereby, other things equal, reducing public savings

As to the inflation rate, the adherence to the fixed exchange rate regime has served the authorities well. It would be important to bring the inflation rate down further, however, in order to maintain external competitiveness. In this regard, the planned reduction in reserve requirements may contribute to inflationary pressures. In the event that the authorities' inflation target proves to be difficult to attain, it would be helpful to consider the imposition of a marginal reserve requirement to slow credit expansion.

On exchange rate policy, the presentation in the staff report on external competitiveness is particularly welcome. Notwithstanding the substantial appreciation of the real effective exchange rate, in terms of admittedly inadequate relative consumer prices, since the peg to the dollar was established, the staff does not conclude that an external competitiveness problem exists. Rather, they look beyond the traditional indicators in their assessment of competitiveness, a position I welcome. The references made to the recent liberalization measures in the trade regime, the reduction in domestic production costs, including lower financing costs, and the growth rate in export volume are all relevant in analyzing external competitiveness. This chair has, for some time, argued that the behavior of real effective exchange rate indices, especially when measured in terms of consumer prices, is by itself an inadequate indicator of competitiveness. Other factors, particularly in an economy undergoing substantial structural changes, must also be considered, and I fully endorse the remarks of Mr. Autheman. With these comments, I support the proposed decision.

Mr. Cserés made the following statement:

Since 1989, Argentina's authorities have been pursuing a comprehensive program of economic adjustment and structural changes in order to reduce inflation to international levels, achieve sustained economic growth, restore external credibility, and free the economy from excessive regulation by the state.

Since I am in general agreement with the staff's appraisal and with previous speakers, I would merely like to focus on two areas of policymaking that could be crucial for strengthening the already achieved convergence of inflation. The important goals of reducing prices and encouraging domestic savings to finance investment will require continued restraint in fiscal and monetary policies.

Remarkable progress has been made in fiscal consolidation since the beginning of the extended arrangement, and the 1994 program foresees further strengthening of the primary fiscal surplus based on continued expenditure restraint and improved tax collections. Although this target is ambitious, it appears to be attainable. Given the need to contain inflationary pressures, any reduction in the rates of social contribution should be made conditional on the realization of a satisfactory revenue path. Therefore, revenue collection, which in the broader sense includes receipts generated by privatization and the financial position of provinces, will require close monitoring to ensure that the authorities' deficit target will be met. It is also essential to avoid any slippage on the expenditure side. Accordingly, I welcome the continued monitoring of quarterly spending limits. Could the staff tell us what specific steps will be taken by the authorities in case any slippage does occur?

Just as it was urgent to overhaul the social security system and to shift to private financing of pensions, it is equally important to pay considerable attention to the reform of provincial finances. These two steps must go hand in hand to achieve a fundamental long-term improvement in the budget position and domestic savings. I was pleased to learn that the authorities have already designed a plan to improve provincial expenditure control, as well as to generate additional fiscal revenue and simplify relations between the provinces and the Federal Government.

While the burden of the struggle with inflation falls on fiscal policy, caution should accompany any move to relax monetary policy, especially through reduction of the desired reserve requirement. As noted during the previous meeting on Argentina, we are worried about any further reduction in the reserve requirement. Have the authorities found a more effective instrument than the reserve ratio requirement for governing monetary policy or sterilizing the expected large capital inflows?

The excessive growth of private sector credit could be another problem area for monetary policy. This rapidly growing demand for credit calls attention to the urgent need to strengthen banking supervision and the institutional basis for surveillance by bank examiners to protect the quality of banks' loan portfolios and safeguard the soundness of the financial system.

Finally, I commend the considerable progress made during the second year of the extended arrangement. We consider this year's program to be ambitious and well balanced, and one that fully merits the Fund's support and could make Argentina one of the best examples of economic recovery and prosperity in Latin America.

Mr. Kaeser made the following statement:

We warmly commend the Argentine authorities for their important stabilization efforts and for the success of their policies. Inflation has declined; the government budget is generating a surplus; trade has been further liberalized; central bank reserves are increasing; and structural reforms are under way. We therefore have no hesitation in supporting the proposed decision. However, the success of Argentine policy is such that we wonder whether the last two purchases of the arrangement should be made.

The choice of an exchange rate anchor to initiate the transition was the right one, as it contributed to restoring confidence in Argentine monetary policy. But with time its negative implications are becoming obvious as it induces strong capital inflows and makes it difficult to follow monetary policy that would check inflation, avoid overheating the economy, and stimulate domestic saving. As confidence in monetary policy is improving dramatically, the Argentine authorities will probably--sooner or later--have to contemplate the possibility of switching to an internal anchor for their monetary policy. For the time being, the Central Bank should by no means follow an accommodative policy. Planned reductions in reserve requirements should be delayed and steps should be taken by the Central Bank to sterilize capital inflows.

We fully share the view of the staff according to which the rapid growth of private credit in recent years, as well as the booming stock exchange, urgently call for a strengthening of banking and financial market supervision.

Sound financial policy is of crucial importance. We commend the federal authorities for the efforts made so far in this field, but a sound monetary policy also requires the cooperation of the provinces. Despite the fact that the Federal Government is pushing strongly for fiscal consolidation in provincial governments, there is still evidence that the provinces have just begun to adjust and still have a long way to go. In this respect, we urge the federal authorities to restrain the provinces from borrowing in order to postpone reforms.

Finally, on structural issues, we welcome the measures to be introduced in 1994 as they will improve the efficiency and resilience of the economy.

Mr. Dorrington made the following statement:

What is striking about Argentina is how well it demonstrates that bold implementation of appropriate policies can bring rewards very rapidly, and these rewards include what Mr. Zoccali refers to as "unprecedented gains in growth." As Mr. Zoccali says, notwithstanding the achievements, there is no room for complacency, and the priorities now are boosting national savings and keeping labor costs competitive. While lower taxes on labor will help to achieve the latter, they risk endangering the former. The fiscal position will need close monitoring, and the authorities will have to remain prepared to adjust policies promptly if public finances are seen to be moving off target.

More generally, effective monitoring and guidance of the economy needs the support of reliable statistics. I understand that the statistical base is still seriously wanting in a number of areas--as mentioned by other speakers--doubtless a result, at least in part, of the difficulty of putting together reliable statistics when inflation was very high. Now that inflation is at more moderate levels, it is both feasible and highly desirable to set about improving the statistical base.

I know that Argentina has been and remains a recipient of considerable technical assistance in this area from the Fund, the World Bank, and elsewhere, and a major revision of the national accounts statistics is due soon. Perhaps the staff could comment further.

The provincial finances are a particular "black hole" in the statistical base--hindering detailed analysis of the overall position of the public finances--and a particular risk to the maintenance of a tight overall fiscal position. I welcome the authorities' attempts to encourage the provinces to put in place the financial and institutional reforms successfully pursued at the national level. I note, in particular, moves to prevent access to deficit financing, and the structural reforms planned under a proposed World Bank provincial adjustment loan. This is a sizable problem area. It is striking that, according to the Ministry of Economy's figures, provincial government expenditure is increasing, and is now nearly one half of total disbursements--while national government spending is falling. In part, this reflects decentralization of spending responsibilities, but this cannot surely explain all of the large increases in the public sector wage bill: the number of public sector employees in the provinces has increased by 50 percent in the decade to 1992.

The third-year program envisages some critically important structural reforms. I agree with Mr. Havrylyshyn that the best response to the increase in the unemployment rate will come through improving labor market flexibility, for which the labor reform bill currently in Congress is a key element. Meanwhile, implementation of the new private pension scheme, without the foreign currency guarantee of the Banco de la Nación Argentina (BNA) pension fund, is key to increasing private savings and developing capital markets.

I note Mr. Zoccali's assurances with regard to risks to the banking sector. Nevertheless, the recent collapse of the Banco Latino in Venezuela has heightened general concern about banks' quality, and there has been some anecdotal evidence to suggest continuing mismatch in the maturity and currency of some Argentine banks' assets and liabilities. I welcome the continuing efforts to tighten capital adequacy and improve supervision of banks. And I can support the proposed decision.

Mr. Kanada made the following statement:

I commend the authorities for the remarkable economic progress, as shown by some of the macroeconomic indicators, resulting from the economic adjustment and reform under the extended arrangement approved in March 1992. It is also welcome that the credibility of Argentina's economy has been enhanced, as evidenced by the bond issue in the international capital market last year and the continued capital inflow.

The second-year program stayed approximately on track, although there were some small slippages in the fiscal performance criteria of end-June and end-September as a result of the unprogrammed tax reduction.

I welcome the authorities' intention not to make the last two purchases under the third-year program, if circumstances permit. The credibility of Argentina's economy would be further enhanced if that intention could be realized.

I have little to add to the concise staff appraisal and would just like to make a few observations for emphasis. On fiscal policy, there was a welcome improvement in the level of national savings, to 14.8 percent of GDP in 1993, although it was below the program target, reflecting improved tax collection and expenditure restraint.

As current expenditure is projected to rise because of wage increases, a takeover of the social security system, and pressures to increase social spending, expenditure control should be strengthened in order to consolidate the primary balance and to avoid slippage on the expenditure side. In this connection, attention should be paid to the expenditures related to the elections in April 1994.

On monetary policy, as pointed out in the staff paper, the planned reduction of the reserve requirement should be delayed in the event inflation fails to decline as programmed. Sterilization of liquidity from capital inflows is also needed to restrain inflationary pressure.

On the external front, since the peso was pegged to the U.S. dollar in 1991, it has appreciated by 28 percent in real terms, thereby reducing external competitiveness. I support the authorities' stance to try to strengthen competitiveness through structural reform, in particular by reducing the tax aimed at lowering production costs and enhancing labor market flexibility. In addition, as reform of the labor market and a reduction in severance pay and overtime compensation will contribute to the enhancement of labor flexibility, early passage of this legislation is desirable.

Finally, judging from the successful achievements so far under the extended arrangement, the authorities' efforts are to be highly commended. It could be said that this extended arrangement has played an effective role in contributing to the attainment of successful economic performance by the authorities. I expect the authorities to maintain the momentum of reform and adjustment, without loosening the reins, in order to further consolidate the gains achieved so far. I support the proposed decision.

Mr. Tetangco made the following statement:

Argentina has made significant strides in reforming the economy, as seen most clearly through disinflation, fiscal consolidation, and renewed growth.

However, as Mr. Zoccali has pointed out, despite good results to date, further efforts will be required. I therefore welcome this third-year program as firm evidence that the authorities have resisted the temptation to rest upon their laurels. Problems remain with the Argentine economy, and Mr. Havrylyshyn has pointed out three specific areas where the authorities must continue to direct their attention--inflation, unemployment, and domestic savings. I agree that improvement in these areas must remain at the forefront of the authorities' attention. However, when taking into consideration the very serious nature of the economic problems Argentina faced just a few years ago, I believe, like Mr. Shaalan, that results to date augur well for continued progress.

The turnaround in the fiscal position has taken Argentina to a position few of us can boast of possessing, namely, a fiscal surplus. Steps to strengthen tax administration have yielded results as evidenced by the large revenue gains. Although there is some uncertainty about the impact of moves to streamline the tax system, some simplification seems warranted, as well as further initiatives to bring evaders into the tax net. The complex relations between central and provincial governments provide impetus for reform, which we agree is likely to result in efficiency gains for the economy.

It is forecast that the expected strengthening of domestic savings will contribute to lower inflation in 1994. An outcome of 0.2 percent for the November to January quarter is indeed a positive start. Further consolidation, as well as successful implementation of structural reform measures, should help reduce some of the concerns this chair expressed during our previous discussion about the continued erosion of competitiveness of Argentina's exporters.

Argentina's expanding number of unemployed remains a cause for concern. Notwithstanding the substantial number of new jobs created over the past year, reducing the current unemployment rate of 9.3 percent is a significant challenge. The set of announced labor market reforms as well as adjustments to the social security system and steps to reduce the cost of employing staff are positive moves. However, I would welcome further information regarding additional strategies to manage the problems of those left unemployed by restructuring, particularly those unable to obtain employment in the new environment without retraining.

We support the requested waivers, and look forward to progress that would allow the authorities' expectation to refrain from making the final two purchases under the arrangement.

Ms. Langdon made the following statement:

We join with others in commending the authorities for the steady progress made during the second year of the extended arrangement. In particular, we welcome the staff's expectation that all performance criteria for 1993 as a whole have been met.

Several aspects of economic performance in 1993 are worthy of merit. Growth has slowed somewhat, but it is now at a level that is more sustainable in the long term. Inflation has been further reduced to 7.5 percent at year's end. In the area of structural reform, we note that the reform of social security is in train and that the privatization program has moved into high gear with the sale of a number of key public enterprises.

The program for 1994 aims at raising national savings so as to make room for increased domestic investment and thus reduce dependence on foreign capital. Here, the program counts on an increase in private savings, given the narrow margin of maneuver that an already balanced budget provides for further fiscal tightening.

To achieve this objective, the authorities intend to reduce provincial taxes and social security contributions. In order to generate a primary budget surplus of 2 percent of GDP, they are counting on improved tax collections and continued expenditure restraint. As the staff points out, this strategy carries some risks. While there is scope for reducing tax evasion, the authorities need to be aware that the measures envisaged could result in revenue shortfalls. In the event, they will have to take prompt corrective measures in order to meet their fiscal objectives. Close monitoring will be even more important in light of their intention to take over the provincial social security systems.

It is also important that federal authorities continue to maintain pressure on the provinces to observe expenditure limits and pursue required financial and structural reforms. While the financial situation of the provinces has improved somewhat, given the extravagant past of certain provinces, vigilance is clearly warranted.

A number of speakers have referred to the persistently high current account deficit. As we have pointed out in the past, the deterioration of the current account should not, in itself, be a source of concern, particularly if it is associated with a recovery in private investment financed. To the extent that the current account deficit reflects private decisions with respect to savings and investments, as opposed to large government deficits, there is less reason for concern.

However, should trends in domestic inflation and the external accounts make it necessary to take action to safeguard competitiveness, given the fixed exchange rate regime, the staff suggests that a further tightening of macroeconomic policies would be necessary, particularly on the fiscal side, in addition to accelerated action on structural reforms to lower costs.

In general, the staff is probably right. However, on the assumption that fiscal consolidation takes place as envisaged, further tightening would undoubtedly be difficult to sell politically in the face of a budget that is already in balance.

On the monetary front, the staff suggests that the Central Bank should delay the planned reductions in reserve requirements and attempt to sterilize capital inflows. In general, we would agree, but we have some reservations about the effectiveness of these measures. While Argentina does not have a "pure" currency board, it is our understanding that the current exchange rate regime offers few possibilities when it comes to sterilization. There is no guarantee that sterilization will be successful if it brings with it an increase in interest rates that would only exacerbate capital inflows. Moreover, maintaining reserve requirements at their current high level risks perpetuating inefficiencies and encouraging disintermediation.

Given the limited margin of maneuver on the fiscal and monetary fronts, it might be the time for the authorities to re-evaluate, as we have suggested in the past, their exchange rate approach and perhaps adopt a more flexible exchange rate regime. If they did so, the peso would probably appreciate against the U.S. dollar, discouraging capital inflows but also moderating domestic inflation. While this might provoke a deterioration in the current account over the short term, this need not be worrisome if developments continue to reflect an increase in capital goods imports which should subsequently boost Argentina's export capacity.

To conclude, the remarkable progress made by Argentina in its macroeconomic and structural transformation under the current extended arrangement merits Fund support, although we are not quite sure what form that support should take. In principle, we can agree to the staff's recommendation that a waiver be granted to allow Argentina to make another purchase without having to wait for the data for the end-December performance criteria. However, we could not help but wonder why Argentina continues to borrow on international capital markets and from the Fund if large capital inflows remain a source of concern. Perhaps the authorities' stated intention not to make the last two purchases under the arrangement goes some way in resolving this paradox.

Mr. Mozhin made the following statement:

Economic developments in Argentina since the enactment of the Convertibility Law in March 1991 present a fascinating story about what a proper mix of economic policies can achieve over a short period of time. Meanwhile, the Fund's involvement in Argentina has been an example of successful cooperation between the Fund and the authorities of a member country.

As I am in broad agreement with the staff's analysis of the most recent economic developments in Argentina, and the staff seem to be in broad agreement with almost every aspect of the economic policy of the Argentine authorities, I will make only a few comments.

On capital inflows and excessive reliance on foreign savings, the authorities' response to the significant capital inflows has been quite adequate. It was necessary, first, to ensure that newly available external financing would result in higher investment rather than in higher consumption. According to the staff report, in 1991-92 real investment grew by about 30 percent a year, while real consumption grew by only about 10 percent a year. This healthy trend continued in 1993, when real investment grew by about 13.5 percent, while real consumption grew by about 3.5 percent. Perhaps this favorable trend is the best proof of the authorities' success in their structural reform efforts, which included tax reduction, deregulation, privatization, and other measures aimed at boosting productivity and improving the investment climate in the country. These same measures will no doubt continue to have a positive impact on the rate of domestic savings in years to come. Although in 1993 an increase in the national saving rate was less than expected under the program, the trend is clearly in the right direction. It has also been important to improve the efficiency of investment. And again, the authorities' efforts to strengthen the financial sector by tightening prudential regulations and improving banking supervision has been a proper response.

The negative trade balance is, of course, related to the problem of capital inflows. The most recent trade figures indicate that import growth is slowing down, while export growth is gathering pace. It is noteworthy that the abolition by the authorities of import tariffs on capital goods has already resulted in a marked increase in the share of capital goods and spare parts in Argentine imports. At the same time, it is clear that reduction of the negative trade balance as a proportion of GDP will be slow. I agree with Mr. Zoccali that the availability of external financing and the creation of investment opportunities will continue to be the main determinants of the trade balance in the near future.

As to the sustainability of a strong fiscal position, my understanding is that prospects for fiscal developments in 1994 are subject to an unusual degree of uncertainty, because the overall impact of the fiscal agreement between the central and provincial governments and the reform of the social security system is difficult to predict. Therefore, I welcome the readiness of the authorities to take any additional measures that may be necessary for the purpose of achieving the objectives of their economic program, as indicated in their letter to the Managing Director.

I agree with Mr. Zoccali that further efforts at improving labor market flexibility will be a proper policy response to the high rate of unemployment. At the same time, it is not clear from the staff report to what extent the authorities are in a position to monitor developments in this area. The data on the rates of unemployment provided in the table on selected economic indicators reflect a percentage of the labor force seeking work in greater Buenos Aires. Are data on the rates of unemployment for other regions and the country as a whole available?

Finally, on an organizational point, it is rather inconvenient to assess program implementation when the data for the end of the program period are not available, especially when the nonavailability of data has to be cited in the Executive Board decision. Perhaps it is a scheduling problem: if the discussion had taken place two weeks later, perhaps the data would have been available. With these remarks, I support the proposed decision.

Mr. Törnqvist made the following statement:

Argentina's overall track record during the second-year program under the extended arrangement has been good. The economy continued to move toward better balance. Many important structural adjustment measures aimed at improving economic efficiency and competitiveness were undertaken or agreed. Improved confidence in Argentina's economic policy was demonstrated by strong capital inflows.

However, there remain problems to be solved. In the previous Board discussion, this chair expressed concern about Argentina's external competitiveness. Even if the risks in this regard seem to have diminished, the situation still warrants attention.

Despite the recent marked deceleration of inflation, the pace of price increases is still too rapid. As a result, and in combination with the peg to the U.S. dollar, Argentina's exchange rate in real terms has continued to appreciate. If this trend is not broken, it will further erode the country's competitiveness. We agree with the analysis in the staff report that competitiveness can best be strengthened through the planned structural reforms. But it will take time before these measures have an effect, and they may not prove to be sufficient. Therefore, the authorities should be ready to take additional measures, primarily by further increasing public savings.

That this is a matter of urgency is clear from the relatively large current account deficit projected in the coming years, together with the fact that Argentina's balance of payments is vulnerable to external shocks, as pointed out in the staff report. Here again, the best remedy is the structural strengthening of the economy. By reforming the economy consistently and decisively, the authorities will be able to strengthen confidence. This will consolidate capital inflows and increase domestic private savings, to the benefit of the external balance.

Noting the satisfactory overall economic achievements, I can support the proposed decision, despite the minor nonobservance of performance criteria for public finances.

Mr. Munthali made the following statement:

We join others in commending, once again, the Argentine authorities for the successful implementation of their Convertibility Plan, which introduced far-reaching reforms. This has resulted in a marked deceleration in the rate of inflation, the restoration of business confidence that has attracted repatriation capital, and the reinvigoration of economic growth. It is indeed encouraging to note that Argentina has joined some of the few developing countries that have resumed access to international capital markets following the debt crisis of the 1980s.

With continued vigilance in the implementation of these reforms, the rate of economic growth should remain robust under relatively stable price conditions. Although early during the expansion the current account deficit widened, reflecting the surge in imports especially of capital goods, the overall balance of payments position, nonetheless, strengthened substantially with a significant buildup of international reserves.

One of the key elements of the adjustment program has been the process of fiscal consolidation, which has involved the accumulation of substantial surpluses in the public sector. This was achieved through, inter alia, strict expenditure containment measures, the reduction of the role of government in the economy by privatizing almost all public sector enterprises, and the enhancement of fiscal revenues. In the event, the contribution by the public sector to the recent increase in domestic savings has been significant.

In the 1994 program, the authorities are, therefore, right in seeking to consolidate these gains. We fully share the views of the authorities that the focus should be on continued fiscal consolidation and the full implementation of the reforms, especially those aimed at strengthening the mobilization of private sector savings and ensuring external competitiveness. In particular, the implementation of the fiscal pact with the provinces and the reform of social security would be important and would help in reducing production costs and strengthening the cash flow and profitability of enterprises. We also share the fears expressed by the authorities regarding the political risks attached to taking further measures to strengthen government surpluses, especially through increased revenue. Nevertheless, the authorities are well advised to remain steadfast and to react promptly in order to ensure that their fiscal stance does not falter.

The staff representative from the Western Hemisphere Department remarked that if fiscal adjustment was deemed necessary, on the expenditure side the staff would emphasize restraint in current expenditure rather than in investment, and it would recommend starting with tax expenditures. In 1993, several such schemes had been introduced--for example, direct subsidies to domestically produced capital goods--that could be viewed as prime candidates in tackling a potential fiscal problem. A second suggestion, which had been discussed with the authorities, tightening the criteria for targeting family allowances.

In general, control over expenditure was difficult in Argentina because of the federal fiscal and social security arrangements, the staff representative commented. As a result, about two thirds of federal expenditures were rigidly determined. Approximately one third consisted of transfers to provinces under revenue-sharing arrangements, that were a function of tax revenues. Of course, if tax revenues did not perform well, there could be some offset, but the system led to rigidity. In addition, social security benefits were, by law, tied to social security tax collections and could not be modified independently. That left only about one third of expenditure subject to direct action.

The staff fully shared Mr. Dorrington's comments on the need to make a major effort to improve statistics in Argentina, the staff representative said. The Fund's assistance included a resident advisor in the Central Bank, who had worked for almost two years on recasting and restoring the monetary statistics of both the Central Bank and the financial system. He was expected to conclude the project in 1994. The Fund was also planning to send a balance of payments expert for a six-month assignment to improve balance of payments statistics. The staff had not been wholly successful in obtaining information on provincial finances. The provinces were not obligated to provide information to the Federal Government, and not all provinces did so. The World Bank had a project supporting reforms of the provincial finances and in that framework was attempting to improve the statistics in that area.

On unemployment, the Government had put forward certain initiatives that might come into play in the near future, the staff representative reported. One scheme was employment bonds designed to provide incentives to provinces to carry out restructuring that could include reductions in employment. Under that scheme, the provinces would continue to pay salaries for a three-year period to employees declared redundant; the money would go into a fund that financed bonds to be given to the redundant workers, equivalent to about 18 months of salary for the separated employee.

If the employee chose to receive the payments, they were amortized over a five-year period with six-monthly payments at market interest rates, the staff representative continued. The employee could also opt to pledge those bonds to private sector employers; in that case, the payment would be made in a lump sum at the end of five years, but the bonds could be used by the private sector firms as security to receive new credit. That scheme was designed to encourage the private sector to expand investment and employment.

The Government's employment strategy also included training schemes, the staff representative added. Also, for all public sector employees who were released as part of restructuring, the Government had been making redundancy payments, covered by privatization revenues. Incremental privatization revenues, to the extent that they were over program target levels, could be used for such schemes under the extended arrangement program.

Data on unemployment came from surveys in about ten of the main urban centers, the staff representative from the Western Hemisphere Department explained. The data reported by the staff for October referred to the total average for the urban areas. For greater Buenos Aires in October, the unemployment rate was 9.6 percent; for the average, 9.3 percent; and for the other urban areas, 8.7 percent. Of course, those figures concealed a fairly wide variation. In some of the outlying urban centers, such as Tucuman, unemployment rates were considerably higher, and in other urban centers unemployment rates were lower than in Buenos Aires.

The staff representative from the Policy Development and Review Department said that the decision required a waiver with respect to the nonavailability of data for end-December 1993 because it had not been possible to have a Board discussion to complete the review before end-1993 as had been contemplated in the arrangement. The delay in the Board discussion was prompted by the need to present to the Board, as part of the review, the program for 1994. Reaching understandings on the program had taken somewhat more time than contemplated. Rather than delay the Board discussion even more by waiting for the availability of end-December 1993 data, it had been decided to proceed with a Board discussion as soon as possible.

Mr. Zoccali made the following concluding remarks:

I wish to assure my colleagues that their remarks will be faithfully conveyed to my authorities. Allow me just a few general observations regarding inflation, employment, and domestic savings to put what has been said in perspective.

First, I would agree that sustaining a process of high-quality growth, such as that exhibited by Argentina in recent years, entails risks. My authorities are well aware that the fast-paced liberalization that they have fostered has served to expose the economy fully to the discipline of markets, which now constitutes the most effective constraint to not abandoning the effort to strengthen macroeconomic credibility, as Mr. Autheman stated. The novel feature is that there is indeed an effort to establish a partnership between the private and public sectors to improve competitiveness, as described by Mr. Mirakhor, but this time based on the elimination of distortions.

Having said this, the fiscal consolidation achieved since 1989, from a combined public sector deficit of 16.5 percent of GDP to a surplus reaching 2 percent of GDP in 1993, should not be downplayed. Moreover, my authorities view the maintenance of fiscal soundness as the crucial determinant for sustaining the growth process. This contrasts with the notion that "the strategy was largely built on the maintenance of the fixed exchange rate." Its success has also been predicated on generating social consensus for dismantling the deep-rooted distortions, noted by Mr. Lanciotti, which in the past had led to hyperinflation and the accelerating deterioration in living standards. These two factors taken together provide a good basis for assessing not only past results but the likelihood of future convergence, including the sustainability of capital inflows.

As the reference to double-digit inflation was mentioned by Mr. Havrylyshyn and others, perhaps it is worth emphasizing in this regard that inflation for the three months ended January was 0.2 percent, while wholesale prices during this period actually declined by 2.7 percent. Available estimates based on the first ten days of February tend to confirm the continuation of the marked deceleration of the previous three months. This leads me to the call by Mr. Autheman and Mr. Shaalan for a broader assessment of competitiveness than that which derives from the strict interpretation of consumer price index inflation. Certainly the deceleration in the rate of inflation tends to downplay the concerns that people legitimately had about the possible overvaluation of the exchange rate.

In my earlier statement I mentioned advancing competitiveness through cost reductions at the microeconomic level. Cost reduction through net labor shedding would be its narrow interpretation. However, by centering their efforts on reducing the extremely large tax and social security contributions wedge on labor--accounting for some 47 percent of wages--while inducing the modernization of provincial structures, my authorities intend to lift the broader constraints to job creation and potential output growth. As a result of these measures, wage costs are expected to decline by some 9-20 percent, affecting squarely the ability of the private sector to generate additional savings.

On the saving/investment performance, the Board's recent discussion on capital inflows recognized the difficulties of additional increases in the fiscal surplus, particularly in countries where social expenditure and infrastructure development have been constrained for many years. The impact in the case of Argentina of higher tax collection on fiscal discipline in the provinces, given the revenue-sharing mechanism and the legal link between pension outlays and average contributions if the social security system is perceived to be in surplus, casts doubts, as remarked by Mr. Autheman, on the effectiveness of relying solely on public savings to sustain the growth process. It is worth noting that my authorities' policy mix translated into 9 percent real GDP growth in 1991/92 and that real expansion in economic activity in 1993 continued to be investment led, which is precisely their policy aim. The share of investment increased from 16.7 percent to 18 percent of GDP, or even higher, depending on the index used to measure construction activity. Even disregarding the impact of the newer technology, the contribution of this increase to productivity growth is significantly higher than a similar increase in the past. The market orientation of investment decisions and the lower relative price of imported capital goods resulting from the elimination of tariffs and the statistical tax on capital goods imports cannot be ignored. At the same time, the share of national savings rose from 13 percent to 15 percent.

In any event, while the current account imbalance, which has declined by some 0.5 percent of GDP in 1993, may be overstated by the lack of distinction between resident and nonresident financial transactions and the service of compulsory bonds issued in 1989 to domestic residents, the greater availability of external financing at lower costs and longer terms should be expected to influence the performance of the trade account in the next two or three years.

Many Directors referred to the issue of reserve requirements. My authorities have been very conscious of its impact on lending capacity. The average reserve requirement is still high and, as Ms. Langdon noted, it does affect the efficiency of intermediation. Yet the authorities have been cautious in 1993 in accelerating discretionary reductions. In fact, the discretionary reduction in 1993 was only 1 percent.

On the issue of sterilization, the framework is one of fiscal surplus, a fixed exchange rate, an open capital account, and, as the staff report mentions, money supply determined by capital flows. Sterilization is deemed cost effective only because the authorities believe that the appropriate variable for equilibrating flows should be domestic interest rates. In fact, the interest rate differential has declined. The interbank offered rate in pesos is 5 percent a year. Therefore, the difference between this adjustment process and earlier stabilization processes in Argentina is the marked decline in interest rates following the sharp decline in inflation.

In sum, the strong tackling of distortional taxation and the reforms in social security and the provinces in a pre-electoral period clearly demonstrate that my authorities are not shying away from the stated aim of narrowing the current account balance and reducing reliance on foreign savings.

The Executive Board took the following decision:

1. Argentina has consulted with the Fund in accordance with paragraphs 4(d) and 4(e) of the extended arrangement for Argentina (EBS/92/46, Sup. 1), as amended, and paragraph 3 of the letter of December 10, 1992 from the President of the Central Bank and the Minister of Economy and of Public Works and Services of the Argentine Republic, in order to review implementation of the economic program for 1993, and establish suitable performance criteria and the frequency of program reviews during the third year of the arrangement.

2. The letter dated December 22, 1993 from the President of the Central Bank and the Minister of Economy and of Public Works and Services of the Argentine Republic shall be annexed to the extended arrangement, and the letters of March 4, 1992, with its attached memorandum, June 18, 1992, December 10, 1992, with its attached memorandum, and June 11, 1993 shall be read as supplemented and modified by the letter of December 22, 1993.

3. Accordingly,

Paragraph 2(c) of the extended arrangement shall read as follows:

"(c) Purchases under this arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 2,066.075 million until September 1, 1994, the equivalent of SDR 2,205.10 million until December 1, 1994, and the equivalent of SDR 2,344.125 million until March 1, 1995.

Paragraph 4(a) of the extended arrangement shall be supplemented as follows: "throughout the third year, during any period in which the data at the end of the preceding quarter indicate that

(i) the limit on overall deficit or surplus of the nonfinancial public sector, or

(ii) the limit on the combined deficit or surplus of the nonfinancial public sector and the Central Bank, or

(iii) the limit on cumulative change in the net domestic assets of the Central Bank, or

(iv) the limit on the cumulative discretionary expenditures of the nonfinancial public sector, or

(v) the target on cumulative change in net international reserves of the Central Bank, or

(vi) the limit on external debt of the public sector, or

(vii) the limit on cumulative net disbursements of short-term debt, or

(viii) the zero limit on external arrears of the public sector, respectively, specified in Table 1 attached to the letter of December 22, 1993, is not observed; or..."

Paragraphs 4(c) and 4(d) of the extended arrangement shall be supplemented as follows:

"(c) if after June 30, 1994, the recently adopted social security law has not been amended as provided in the letter of December 22, 1993, or

(d) after June 30, 1994 and December 31, 1994, until the reviews of the program contemplated in the last paragraph of the letter of December 22, 1993 are completed, or"

4. The Fund decides that the second review contemplated in paragraph 4(d) (the seventh review of the program) and the review contemplated in paragraph 4(e) of the extended arrangement for

Argentina, as amended, are completed, and that notwithstanding its paragraph 4(a) with respect to the nonavailability of data for end-December 1993 performance criteria, Argentina may proceed to make purchases under the arrangement up to the equivalent of SDR 1,760.10 million until March 1, 1994.

Decision No. 10583-(94/11), adopted
February 14, 1994

2. SUDAN - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING SUSPENSION OF VOTING RIGHTS

The Executive Directors considered a staff paper on the review of the decision, adopted August 6, 1993, to suspend the voting rights of Sudan (EBS/94/10, 1/28/94; Cor. 1, 2/2/94; and Sup. 1, 2/2/94).

The staff representative from the Treasurer's Department reported that, since issuance of the staff paper, net SDR charges had become overdue and quarterly charges would become due on February 17, 1994. Taking account of a small amount of burden-sharing refund, Sudan's overdue obligations totaled SDR 1,168,896,981.

Mr. Dlamini made the following statement:

At a time when "global cooperation" is becoming the watchword of the international community, it can only be seen as regrettable that we are meeting to consider whether to initiate the procedure on compulsory withdrawal of a member from the Fund. But while it seemed inevitable that the timetable of actions under the strengthened arrears strategy would lead to such a situation, it is not too late to apply flexibility that would move us at least one step back from the brink. I believe the alternative decision proposed in the staff paper creates such a room for maneuver.

To say that the Sudanese authorities are managing their economy under very difficult circumstances is, perhaps, an understatement. Foreign exchange is very scarce, and this is a problem that is at the heart of the severe economic problems facing the country. Meanwhile, the country's inability to service its debt has led to a vicious circle of suspensions of loan disbursements from multilateral institutions, which in turn saps its ability to produce and earn the foreign exchange needed to reduce the debt burden. This vicious circle has only become more severe with the absence of donor assistance which has been critical in helping to keep the economy afloat, even in better times.

I cannot say much at this stage, except to reiterate that the authorities are concentrating on increasing production, especially in the agricultural sector, and on streamlining government expenditure in order to tame inflation. The central bank has also tightened credit to the private sector as part of the anti-inflation drive. The exchange rate was depreciated in October 1993, and as the staff has reported, the exchange system is expected to be reviewed soon.

Payments to the Fund have been lacking, not because of an unwillingness to pay, but because of the inability to pay. The authorities have indicated on a number of occasions that this was the problem, as they have had to struggle to use the available foreign exchange in ways that would keep the economy from total collapse.

The expulsion of Sudan from Fund membership will be harmful not only to Sudan itself, but also to the Fund. As a nonmember, it would be more difficult for both sides to find a solution to the problem of arrears than if the country were to remain part of the Fund. It would seem to be more appropriate to find other ways of dealing with the problem, including helping Sudan to be in a position to implement needed measures to restore its economy and so to be able to settle its arrears to the Fund. Realistically, there is a limit to what the social and political structure of a country can bear when it comes to adjustment, especially in the absence of international financial assistance.

Mr. Shaalan made the following statement:

When the Articles of Agreement were amended to empower the Fund to suspend voting and related rights, it was hoped that the deterrent effect of the suspension provisions would obviate the need to actually invoke them and would thereby halt the process leading to the ultimate sanction of compulsory withdrawal. It is most regrettable that this strategy has not worked as was hoped, and the Board, six months following the suspension of Sudan's voting rights, has before it a draft decision noting the intention to promptly initiate the compulsory withdrawal procedures.

In trying to come to a view on this proposed course of action, which by no means is an easy task, several issues should be carefully considered.

First, moving to implement the ultimate remedial step under the Fund's arrears strategy would imply that the Board has completely given up on the "carrot" aspect of the strategy and has concluded that, if the remedial aspect of the strategy is still to work as a deterrent, it should do so between the time of initiating the withdrawal procedures and that of its adoption by the Board of Governors. While there is in the present case that which could justify giving up on the cooperative side of the arrears strategy, it is far less clear that one could at all be certain that initiating the procedures on withdrawal would lead to a resumption of active cooperation with the Fund during the period leading to a vote by the Board of Governors.

An important issue that should be raised in assessing the prospects of a resumption of cooperation relates to the extent to which compulsory withdrawal may be seen to contribute incrementally to the punitive effects of persistent failure to meet membership obligations. I suspect that in Sudan's present circumstances, these effects may not be seen as amounting to much. Its relations with the donor-creditor community are already severely strained, and, as reported in the staff paper, the World Bank and IDA placed Sudan last month in nonaccrual status. Therefore, the termination of membership in the Bank, which would automatically follow withdrawal from the Fund unless the Bank decides otherwise by a majority of 75 percent of the total voting power, may not be seen in the present circumstances as representing a meaningful deterrent.

Second, the Articles require that upon withdrawal of a member, agreement on the settlement of its financial obligations to the Fund must be reached within six months. The experience in the four cases of withdrawal from the Fund in this regard is documented in the staff paper on the financial consequences of compulsory withdrawal that was circulated to the Board for information about three years ago (EBS/90/216, 12/20/90). As reported in that paper, settlement agreements were reached and implemented in the four cases in question, including in the single case of compulsory withdrawal, which, incidentally, did not result from failure to fulfill financial obligations to the Fund.

This experience notwithstanding, the possibility exists that, in the circumstances that led to giving consideration to compulsory withdrawal in the case of Sudan, no schedule of payments could be agreed. But even if agreement on such a schedule were judged to be feasible, how confident can one be in the present circumstances that the agreement would be fulfilled? I submit that this kind of evaluation must be conducted in order to bring into clear focus the full range of financial consequences of compulsory withdrawal.

Assuming for the time being that such evaluation would lead to the likely conclusion that there is value impairment of the Fund's assets and that therefore there exists a probable loss, how is this loss going to be recognized? The staff examined the general aspects of this issue in the paper I referred to earlier. They indicated that insofar as General Resources Account obligations are concerned, provisions for probable loss could be financed from precautionary balances in the Special Contingent

Account (SCA-1) or, if necessary, charged to the Fund's current income. Again, these issues were examined in a general context. But how do they apply, and what do they imply for the membership, in the case of Sudan? This matter should be addressed in specific terms. The full range of options should be explored and the financial consequences of each option identified and quantified. Perhaps it would also be useful to compare these consequences with the financial implications of freezing the Fund's relations with Sudan, although I fully recognize that the latter is not an option under the arrears strategy.

Third, as is well known, to be adopted compulsory withdrawal requires a majority of 85 percent of the total voting power in the Board of Governors. No one can forecast what will happen, but the consequences of failure to secure this majority should be carefully weighed before initiating the procedures for compulsory withdrawal.

I can well appreciate the strength of the argument that failure to proceed with the next step on the ladder of remedial measures within the agreed timetable for doing so would undermine the credibility of the Fund's arrears strategy. It is worth recalling, however, that it has always been recognized that, at all stages in the timetable, the Board retains the discretion to apply it in a flexible manner. As stated in the summing up of last spring's discussion of overdue financial obligations to the Fund (EBM/93/49, 4/15/93), "Directors noted that the agreed timetable of procedures had been applied at various stages with a reasonable degree of flexibility...."

I submit that, if exercising discretion was appropriate, or at least acceptable, in the application of the initial remedial measures, it surely should be all the more so when it comes to applying the ultimate sanction of compulsory withdrawal.

Draft decision B provides for a degree of flexibility that, for the reasons I mentioned, is called for, and I can therefore support it.

Ms. Lissakers made the following statement:

When the Board suspended Sudan's voting rights in August 1993, it was clear that under the strengthened arrears strategy, compulsory withdrawal proceedings might have to be contemplated unless active cooperation with the Fund resumed in the next six months. Half a year has now passed without any change for the better. We fully agree with the staff's assessment that Sudan cannot be considered to be actively cooperating with the Fund to resolve its financial obligations. In fact, there is no sign of any real effort to meet even a minimal threshold of active cooperation as judged by the two customary tests: payments and policy performance. Let me turn briefly to those issues.

In 1993, Sudan's payments totaled less than $1.2 million, a minuscule percent of obligations falling due, compared with the roughly $48 million annually in payments that would be necessary to keep Sudan's arrears from rising further. Moreover, no payments have been made since August, as the authorities failed to meet even their own self-imposed schedule of token payments. Finally in this connection, while Sudan continued to accumulate massive external arrears, the minimal debt-service payments it has made over the past year have clearly not taken the Fund's preferred creditor status into account.

As if this were not enough, policy performance has been deplorable, as Board members widely recognized in August 1993 and again at the time of the Article IV consultation in November 1993. From the staff's report on its January visit to Khartoum, it is clear that the authorities still do not have a workable economic strategy to deal with their massive problems, much less an approach that the Fund could endorse.

Furthermore, while the authorities again expressed interest in increased cooperation during the recent staff visit, as well as their intention of making a payment prior to February 4, we have to conclude from their inaction on both fronts that once again official pronouncements ring hollow. We would also note that in contrast to the official view, sharp declines in foreign assistance and shortages of foreign exchange are not the result of exogenous factors outside the control of the authorities, but rather the result of their own irresponsible policies.

Meanwhile, Sudan's relations with other major international institutions sank to a new low in January, as both the World Bank and African Development Bank placed Sudan in nonaccrual status; the speed with which Sudan was expelled from the Arab Monetary Fund several months ago is also noteworthy. With the near-total deterioration in relations with bilateral aid agencies and non-governmental donors that Sudan's official policies have already caused, the authorities have now cut off access to nearly every conceivable source of external assistance.

As Sudan has provided no evidence of improved cooperation, and in fact has persistently and blatantly not cooperated with the Fund, we firmly believe that for the good of this institution, and all its members in good standing, compulsory withdrawal procedures should be initiated at this time. We thus strongly support draft decision A. Furthermore, we think any postponement of this decision at this time would be a serious mistake, as it would send exactly the wrong signal worldwide. Let me be specific.

First, we find it highly unlikely that postponing action will induce the authorities to come to grips with their situation, given their track record of unfulfilled commitments and broken promises, as well as current policies and attitudes. If we do not move now to start these procedures, the substance and timing of which are called for under the strengthened arrears strategy that has repeatedly been endorsed by the Board, we would send the wrong signal about our resolve in this matter to the Sudanese authorities and to the small handful of other members that are not living up to their financial commitments.

Sudan's $1.6 billion in arrears, furthermore, pose an ever greater burden on all members of the Fund, including current and prospective borrowers, who face lower Fund liquidity and higher rates of charge. At this time of increased demand for Fund resources, including from a number of countries in Africa that are preparing to move to Fund-supported programs, it is necessary for the financial credibility of this institution that the strengthened arrears strategy be applied fully, and that we not create the perception that the Fund's preferred creditor status does not have to be respected.

In response to those, like Mr. Shaalan, who think that action should be postponed while we study the financial implications, I would make a couple of observations. First, as noted in the staff paper, the Board has already requested and received a paper prepared by the staff on the financial consequences of compulsory withdrawal (EBS/90/216). Perhaps the staff could indicate whether applicable Fund policies have changed since that paper was prepared; I doubt it.

Second, the Board has frequently discussed the issue of precautionary balances, with a particular view toward increasing reserves to cover possible loan losses and the implications of that process.

Third, with SDR 2.2 billion in precautionary balances, the Fund clearly has more than adequate reserves to cover those overdue obligations which, if written off, would constitute net General Resources Account obligations. We have set aside reserves to help cover obligations that ultimately appear to be uncollectible; having taken that tough step, we should apply the same practices required of any responsible financial institution.

Fourth, if Sudan is forced to withdraw, the Board, with the guidance of the staff of course, will have leeway in determining the manner and timing of the financial aspects that would need to be addressed, even as we continue to pursue those obligations. I too would welcome further staff comments on this issue.

Finally, this institution is founded on the principle of mutual support and mutual responsibility. When members accept the support but reject their responsibilities, they undermine that founding principle. This is not just an issue that affects Sudan. The Fund has admitted a large number of new members to its ranks and it is essential that these members, as well as other members, understand this important principle of collective responsibility, as well as support. We recognize that certain circumstances may make it difficult for a member to fulfill the obligations and that many members operate under tremendous economic strain--sometimes of their own doing, oftentimes not. This institution has created special facilities, which we have strongly supported, to assist those countries that need special support in order to meet their obligations--I would refer to the ESAF successor and special arrears-clearing efforts that often include bilateral support. These efforts cannot be sustained if they are not met by at least a minimum of goodwill and good faith effort on the part of the recipients.

The Sudanese authorities have had every reason and have been given every opportunity by the staff, by the management, and by the Board to improve their cooperation over the past six months, yet they have chosen to do nothing to improve the situation. At the same time, the Fund and its members continue to be forced to subsidize Sudan's irresponsible behavior even as the authorities make a mockery of the obligations of Fund membership and the arrears strategy.

Ultimately, it is the people of Sudan who pay the terrible price for these policies. We do not believe that the Fund should continue to accept the situation; we should take the next step in the strategy that has already been agreed by this Board and supported by this Board.

Mrs. Wagenhoefer said that she could go along with most of the arguments put forward by Ms. Lissakers. In particular, it was deplorable that during the staff's visit to Khartoum one month previously, the authorities had not suggested any forthcoming change in their actions that would indicate an intention to alter the stance of economic policies. Therefore, she fully supported the staff's assessment that Sudan could not be considered to be actively cooperating with the Fund toward finding a solution to the problem of its overdue financial obligations to the Fund, and she endorsed draft decision A.

Mr. Autheman recalled that during the Board's discussion in August 1993 (EBM/93/114), his chair had expressed some doubts about the timing of the Board's decision and had considered that Sudan should have been given a final chance for cooperation, a few weeks before the Article IV consultation. Since that time, Sudan had been offered several opportunities to resume cooperation with the Fund and had seized none; especially, the authorities had not taken the opportunity created by larger than expected export earnings and private transfers to resume payments to the Fund.

The issues of consistency and credibility had to be considered, Mr. Autheman remarked. Once the Board had taken a decision, it had to follow through. The Sudanese authorities had full control of the political and economic situation of the country; thus no excuse could be found in their domestic circumstances. Yet, the authorities had offered no signal that they would be ready to move toward a cooperative approach. Consequently, the Fund had to take the appropriate decision.

His chair had also expressed doubt in the past about the efficiency of the deterrent aspect of the procedure in the arrears strategy under consideration, but it was no longer the time to consider the pros and cons, because the credibility of the Fund was at stake, not only vis-à-vis Sudan, but also vis-à-vis every country that could be tempted to follow a similar uncooperative approach, Mr. Autheman observed. For all those reasons, he supported draft decision A. It would be necessary to address promptly the next steps to be taken and the financial consequences of that decision.

Mr. Dorrington made the following statement:

> It is important that the Fund follow the strengthened arrears strategy. Arrears are a serious problem. They undermine the cooperative nature of the institution and impose a heavy financial cost on all members, particularly developing world members, through the burden-sharing arrangements. The Fund Board must be seen to be firm in its treatment of arrears cases but prepared to be flexible if there is reason to give the benefit of the doubt.
>
> There is no evidence that Sudan has resumed cooperation with the Fund. Therefore, there is no reason to deviate from the timetable of actions under the strengthened arrears strategy by supporting decision B. Sudan has not made any payments to the Fund since suspension, neither has it put in place appropriate economic policies or shown any sign of doing so; therefore unambiguously Sudan cannot be considered to have resumed active cooperation with the Fund. Thus, I support draft decision A.
>
> Assuming decision A is adopted, it will be some time before the actual Governors' vote is taken, and there is still ample time for Sudan to demonstrate clearly its willingness to cooperate with the Fund. I hope it will, but I cannot find any reason for optimism. The last Article IV consultation staff report (EBS/93/222) illustrated the benefits of following appropriate economic policies, and earlier today we saw in the case of Argentina how quickly good policies can deliver benefits.
>
> Finally, as mentioned by Mr. Shaalan, compulsory withdrawal from the Fund would have potentially serious implications for

Sudan's membership of the Bank. Could the Secretary tell us how the Bank will be formally informed of the Fund's proceedings at each stage.

The Secretary said that a representative of the World Bank was present for the discussion. Also, because of the linkages with the decision-making process of the World Bank, he would keep the Secretary of the Bank informed of the outcome of the meeting.

Mr. Smee made the following statement:

The staff has concluded that Sudan cannot be considered to be actively cooperating with the Fund toward finding a solution to the problem of its overdue financial obligations. We agree with the staff's conclusion that Sudan has persisted in its failure to fulfill its obligations under the Articles of Agreement and to cooperate actively with the Fund. But we are unsure as to what course of action the Board should take today.

The Third Amendment of the Articles of Agreement empowers the Board of Governors to suspend the rights of members in cases of continuing breach of obligations. This Board suspended the voting rights of Sudan effective August 9, 1993--a decision that effectively stripped Sudan of all rights in the Fund. To be more precise, Sudan is not permitted to vote, has no representative on the Board, is ineligible to use Fund resources, cannot participate in the appointment of officials, and cannot attend meetings of the Board of Governors, the Council, or the Board of Directors, and so forth.

The country has, de facto, been expelled from the Fund, under the Amendment to the Articles of Agreement. The Board is now faced with the decision of whether to make this expulsion de jure. My authorities believe that the initiation of the procedures for compulsory withdrawal should be delayed for a further six months. This would afford Sudan one last opportunity to adopt policies that will address its balance of payments problems and begin settling its arrears to the Fund.

We would encourage other chairs to join us now in giving Sudan one last chance. If, however, Sudan fails to seize this last opportunity over the next six months, we would support a decision to initiate procedures for compulsory withdrawal at that time.

Thus, we support draft decision B, but we would ask Directors to provide Sudan with a clear and unequivocal directive to begin cooperating with the Fund or face the initiation of procedures in six months' time.

The Chairman commented that Mr. Smee's concept of de facto expulsion could cause some difficulties in light of the extensive negotiations that were taking place between the Fund and the Sudanese authorities.

Mr. Smee explained that by referring to de facto expulsion he meant that Sudan, under the Third Amendment, no longer had the voting and other rights of a member of the organization. The Board would now have to decide whether Sudan's lack of active cooperation had reached the point where Sudan should in a legal sense be expelled. After considering the Third Amendment and the final step in the arrears strategy, he believed that Sudan should be afforded another six months.

Ms. Lissakers pointed out that even under draft decision A, a number of steps and some period of time remained until the action of compulsory withdrawal would actually proceed, during which the Sudanese authorities could show their serious intention to clear their arrears and to resume cooperation with the Fund. The process was not inexorable and could be halted at any time at the wish of the Board; but she saw no basis whatsoever at present time to halt the procedures.

Mr. Mirakhor recalled, in the context of Ms. Lissakers' comment, that the Board had discussed many times the fact that the strategy of expelling a member from the Fund was not symmetrical in the sense that, once a member was expelled, the way back for all practical purposes remained closed. Therefore, he endorsed draft decision B.

Mr. Dorrington said that he believed that in the only previous case of compulsory withdrawal, the member had rejoined the Fund. He agreed with the point made by Ms. Lissakers. For the benefit of clarity, it would be useful if the staff could outline the approximate timetable that would be followed for compulsory withdrawal.

Mr. de Groote made the following statement:

> I support draft decision A to initiate the procedure under Article XXVI, Section 2, with respect to Sudan. Our position is motivated by the lack of cooperation shown by the Sudanese authorities, by their failure to implement sound macroeconomic policies, and by the need to preserve the Fund's credibility under the strengthened arrears strategy. I agree with the arguments presented by my colleagues in this direction, and I will simply add one consideration relating to the fundamental mechanism on which the Fund's operations are based.
>
> Fund credits are not donations; their counterpart represents liquid reserves for the countries that have provided their currency to finance those drawings. It could become difficult to maintain the concept that we are in fact responsible for part of our membership's reserves if doubts arise about the liquidity of those reserves.

Finally, let me point out that voting to initiate the procedures on compulsory withdrawal does not automatically imply a later vote in favor of Sudan's withdrawal at the next review. The Sudanese authorities still have time to take appropriate steps to start repaying the institution and putting into practice their intention to adjust their economy.

Mr. Lanciotti made the following statement:

I will avoid listing the events that, in past years, have clearly shown the constant disregard on the part of the Sudanese authorities of the repeated warnings by the Executive Board, because it would be a mere restatement of the contents of the staff document and of many previous speakers' remarks. At this juncture, I want only to express, once more, the sense of disappointment deriving from the frustrating results of the present review.

This chair has always welcomed any sign of improvement in Sudan's economic performance as well as any sign of a cooperative attitude by the Sudanese authorities as to the possible beginning of an improved relationship with this institution. This is why we find it particularly unpleasant to have to admit that the efforts devoted by the staff to provide advice, and by the Executive Board to induce the country's authorities to restore normal relations with the international financial community, have not led to the appropriate results.

The Board now faces a decision of exceptional harshness. Indeed, it could involve the compulsory withdrawal of Sudan from the Fund, which would have dire implications for a country already in great difficulties. At the same time, it is apparently not viable to offer a better alternative to the Sudanese authorities, who have constantly overlooked the gravity of their financial position as regards this institution. The Fund is based on the commitment by the member countries to accept and respect the Fund's rules which the countries themselves have established in the common interest. It is hard to imagine that these rules can be violated without serious damage to the credibility of the rules themselves, to the institution, and, therefore, to the common interest. With regret, I support draft decision A.

Mr. Kaeser made the following statement:

The staff paper once more concludes that Sudan is not actively cooperating with the Fund toward finding a solution to the problem of its overdue financial obligation, and I fully agree. Progress in formulating appropriate economic policies has been disappointing. Despite the many promises, the Sudanese authorities fell short of implementing the measures suggested by the staff to adjust their economy. The Sudanese authorities did not take advantage of the six-month delay since the suspension of their rights to improve their record.

Sudan has had outstanding obligations to the Fund since 1984. On January 24, the arrears amounted to nearly SDR 1.2 billion, SDR 84 million of which was vis-à-vis the Trust Fund. There is no indication that the payments performance will improve in the future; in 1992/93, Sudan paid to the Fund only SDR 2.1 million of the SDR 52.9 million falling due. Since the suspension of its voting rights, Sudan has made no payment to the Fund, notwithstanding the authorities' commitment to pay at least US$0.3 million a month--one more demonstration of Sudan's unwillingness to recognize the preferred creditor status of the Fund.

This situation of growing arrears, with no clear indication that would provide some optimism for the future, is clearly not sustainable. On the one hand, the credibility of our institution is at stake; on the other, it makes no sense to let arrears accumulate for which the Fund has to make provisions at increasingly higher costs for the membership as a whole. If Sudan is forced to withdraw, the Fund will probably have to accept a loss. I can share some concern expressed by previous speakers in this regard. But on the grounds of realism I would rather follow an old German saying according to which "it is better to face an end with pain, than a pain without end."

Therefore, given the increasing outstanding obligations to the Fund and Sudan's reluctance to cooperate, I support draft decision A and urge the Executive Board to initiate promptly the procedures under Article XXVI, Section 2(c) with respect to Sudan. Any postponement would send the wrong signal and undermine our credibility.

Mrs. Srejber made the following statement:

The persistent failure of Sudan to fulfil its obligations under the Articles of Agreement and to cooperate actively with the Fund is evident from the staff paper. This chair deeply regrets the still-lacking active cooperation of the Sudanese authorities with the Fund in solving the arrears situation, which has been continuous since 1984.

Furthermore, recent developments paint a picture of an economy in serious disarray, and I am in broad agreement with the staff that most worrisome is the lack of a comprehensive and coherent approach to financial policy formulation. With these comments, this chair supports draft decision A--that is, to promptly initiate the procedure on compulsory withdrawal of Sudan from the Fund.

Mr. Wei made the following statement:

> I associate myself with the views of Mr. Dlamini, Mr. Shaalan, and those Directors who supported draft decision B. Like other Directors, we regret that the authorities could not make sufficient payments to the Fund. As pointed out in the paper, during the staff visit to Khartoum about one month ago, the Sudanese authorities welcomed the opportunity for dialogue and reaffirmed their willingness to seek a cooperative solution to their problems with the Fund. Also, the authorities are committed to continuing their economic reform strategy. Meanwhile, they are making efforts to improve relations with potential donors to help ease the external resource constraint. If we look at the Sudanese economy in terms of GDP growth in recent years, its performance is better than that of some other developing countries.
>
> This being said, we can endorse draft decision B. We sincerely hope that the authorities will continue their economic reform policies and make a concerted effort to increase their payments to the Fund.

Mr. Geethakrishnan noted that the staff had concluded that Sudan could not be considered to be cooperating with the Fund toward finding a solution to the problem of its overdue obligations. Thus, after deciding in August 1993 that the voting rights of Sudan should be suspended, the logical action for the Board to take now would appear to be to recommend to the Governors that compulsory withdrawal was the only solution.

While that decision appeared to be logical, it also appeared to be too final, Mr. Geethakrishnan continued. As some Directors had pointed out, there would still be time, if the Board decided in favor of draft decision A, for Sudan to set its house in order before the voting by the Governors took place; but, de facto, such a message effectively broke down the dialogue between the Fund and the country. He believed that there was merit in the recommendation of Mr. Smee, Mr. Dlamini, and Mr. Wei to give the Sudanese authorities one last chance. Therefore, his chair supported draft decision B while urging the Sudanese authorities to take immediate steps to get back on the track of reform and to normalize their relations with the Fund.

Mr. Zoccali made the following statement:

> While the staff in its recent update indicates a faster than projected growth of GDP and export receipts, it is regrettable to learn that since the suspension of its voting rights on August 9, 1993, Sudan has made only limited progress in the implementation of appropriate economic policies and no payment to the Fund during this period vis-à-vis the minimal commitment of US$0.3 million a month.

Sudan's failure to resume active cooperation with the Fund and to create the conditions for catalyzing the urgently needed assistance of the international donor community is a domestic tragedy that affects the entire community of nations. It is to be hoped that the authorities' reiterated desire for a normalization of relations with the Fund will soon translate into a specific policy framework for stabilization and reform that can be endorsed by this Board.

My authorities view the initiation of the procedure on compulsory withdrawal at a time of virtual universality of Fund membership not just as another step of remedial action. They also see merits in acting consistently with the established strategy for resuming active cooperation to re-establish collective support. On balance, my constituents are split over the alternatives under discussion. Argentina supports draft decision A, while other members generally tended to favor draft decision B. Consequently, the position of this chair is to abstain.

Mr. Santos commented that he endorsed the arguments made by Mr. Shaalan and Mr. Dlamini against initiating the procedures on the compulsory withdrawal of Sudan. Therefore, of the two possible courses of action proposed by the staff, he supported draft decision B.

Mr. Waterman made the following statement:

It is both disappointing and frustrating that Sudan has not responded to the numerous opportunities given to it to improve its cooperation with the Fund. Therefore, I agree with the staff, and many other speakers, that Sudan cannot be considered to be actively cooperating with the Fund to find a solution to its arrears problem.

Members within this constituency hold differing views on the two options before us today. While Korea prefers draft decision B, the majority of this constituency favors draft decision A, given the seriousness of the situation and the lack of cooperation on behalf of the Sudanese authorities.

Accordingly, I add my voice to those Directors who have indicated a preference for draft decision A, but like others it remains our sincere hope that Sudan can act to improve cooperation between now and any final vote by Governors.

Mr. Fukui observed that draft decision A proposed the initiation of the procedure toward compulsory withdrawal--a decision, as pointed out by other Directors, that was serious and crucial, and called for careful consideration.

Despite the Fund's efforts to encourage the Sudanese authorities to normalize relations with the Fund, the authorities had failed to respond, Mr. Fukui remarked. Meanwhile, several countries in arrears to the Fund had taken significant steps to clear their overdue obligations, under difficult circumstances, through measures such as the rights accumulation program. Japan was actively supporting those countries making strong efforts to settle their arrears, on the basis of clear evidence of those efforts; unfortunately, in the present case, there was no such evidence. Consequently, after taking account of all those factors, he felt bound, regretfully, to support draft decision A.

Mrs. Hetrakul stated that her chair would abstain from voting on the proposed decision.

Mr. Kafka observed that nothing could be said in defense of the behavior of the Sudanese authorities. If that were all, his conclusion would be clear; but the present case was only the second in the history of the Fund in which the Board was faced with a proposal to initiate compulsory withdrawal of a country from the Fund. Under those circumstances, he recommended giving Sudan another six months to ponder the serious consequences it would face if it did not resume active cooperation with the Fund. Therefore, he supported draft decision B.

Mr. Mirakhor said that his views had already been expressed by Mr. Dlamini, Mr. Shaalan, Mr. Smee, and Mr. Kafka. His chair supported draft decision B.

Mr. Al-Tuwaijri stated that his chair endorsed draft decision A.

Mr. Marino noted that he shared many of the comments made by Mr. Shaalan and Mr. Smee. Given the circumstances of Sudan, and in the context of appropriate application of the Fund's arrears strategy, more time was warranted. The full impact of the suspension of voting rights was only beginning to be felt by Sudan. He hoped that the additional time would be used to achieve the renewed cooperation of Sudan with the Fund. Therefore, he supported draft decision B.

Mr. Mozhin said that his chair remained convinced that the rights accumulation program was the only viable option for Sudan to improve relations with the Fund and the international financial community in general. It was regrettable that thus far there had been no indication from the Sudanese authorities of their willingness to resume active cooperation with the Fund. Under those circumstances, he did not see sufficient reason for any further postponement of the procedures prescribed by the Articles of Agreement, and he supported draft decision A, with the understanding that, should the Sudanese authorities indicate their willingness to resume active cooperation with the Fund, there was still a possibility to reverse the process.

The staff representative from the Treasurer's Department explained that if draft decision A were adopted, the initiation of the compulsory withdrawal procedures would begin with the issuance of a complaint--in the present circumstances, by the Managing Director. Thereafter, several steps had to be followed. The complaint would be noted by the Executive Board, at which time the Board would decide whether to place the complaint on its agenda for formal substantive consideration; in setting a date for the latter, the Board must take into account the need to inform the member in sufficient time to give Sudan adequate opportunity to respond, both orally and in writing. Then, assuming the Board in its substantive consideration agreed to recommend compulsory withdrawal to the Board of Governors, again the Sudanese authorities would have to be given adequate opportunity to present their case, both orally and in writing, to the Board of Governors. The procedure implied that there would then need to be a meeting of the Board of Governors. Unless it were considered important to call a special meeting of the Board of Governors, consideration by the Governors of the recommendation of the Executive Board could take place at the time of the Annual Meetings.

The Chairman noted that the majority supported adoption of draft decision A, but he wished to assure all members of the Board, and particularly those who preferred draft decision B, that no effort would be spared to persuade the Sudanese authorities to change their course of action and to cooperate with the Fund in a convincing manner. It would benefit them and the international community to do so. Meanwhile, it was necessary to preserve the credibility of the Fund and its procedures.

Mr. Dlamini thanked Executive Directors for their continued interest in Sudan. Of course, his authorities would have preferred adoption of draft decision B, and they would be disappointed by the Board's decision. His authorities appreciated the work of the staff, especially its role in keeping the lines of communication with the Fund open.

The Chairman stated that decision A had been endorsed by the members of the Board. He would send a communication to the Sudanese authorities to report the views of Directors expressed during the discussion and to ensure that the authorities understood the opportunities that remained available to them for avoiding compulsory withdrawal. The Board would be kept informed of further developments.

The Executive Board took the following decision:

1. The Fund has reviewed Decision No. 10443-(93/114) in light of the facts and developments described in EBS/94/10 (1/28/94).

2. The Fund notes that Sudan has been in continuous arrears to the Fund since July 1984, that Sudan was declared ineligible to use the general resources of the Fund effective February 3, 1986, and that Sudan's voting rights were suspended effective August 9, 1993. Sudan has persisted in its failure to fulfill its obligations under the Articles after the expiration of a reasonable

period following the decision of suspension taken pursuant to Article XXVI, Section 2(b), and has not cooperated actively with the Fund with a view to resolving the problem of its overdue financial obligations to the Fund. In view of these circumstances, the Executive Board notes that it is intended to initiate promptly the procedure under Article XXVI, Section 2(c) with respect to Sudan.

Decision No. 10584-(94/11), adopted
February 14, 1994

At this point, the Executive Board agreed to adjourn and to resume discussion at 2:30 p.m.

3. ZAIRE - OVERDUE FINANCIAL OBLIGATIONS - REPORT ON COMPLAINT WITH RESPECT TO SUSPENSION

Executive Directors considered a staff paper on the Managing Director's complaint with respect to suspension of voting and related rights of Zaïre (EBS/94/7, 1/19/94; and EBS/94/8, 1/19/94).

Mr. Autheman made the following statement:

During the previous discussion on Zaïre (EBM/93/166 and EBM/94/167, 12/8/93), Directors agreed to "initiate promptly"--promptly meaning rather slowly--the procedure leading to consideration of suspension of Zaïre's voting rights. At that discussion, we expressed a dissenting view, based on our assessment of the political situation in Zaïre. That assessment was--and still is--that no government was able to act on behalf of Zaïre. I still do not understand the position taken by the staff on that matter. The facts support the position of this chair, and little political progress has been achieved in Zaïre. The Birindwa Government, which was supposed to be able to act on behalf of Zaïre, no longer exists. Although Bishop Monsengwo has been able to foster some agreement among divided parties, there is still no agreement between President Mobutu and Bishop Monsengwo on the compromise solution to be reached in the case of Zaïre.

It is important to stress the political aspect of the situation of Zaïre, because it is not possible to assess the willingness of Zaïre to engage in the enhanced cooperative strategy without a Government able to act on its behalf or to conduct negotiations with the Fund. The complexity of the political situation calls for cautiousness. We should not exclude the possibility of a dramatic improvement in the political dialogue in the coming months. France and two other countries are continuing efforts aimed at resolving the political crisis. Once that crisis is abated, the situation would be different and would call for an in-depth consultation between the new Zaïrian authorities and the Fund. I hope that some progress will be possible before May 1994. If so, I hope that the proposed deadline for the consideration of suspension of Zaïre's voting and related rights will be interpreted as an interval during which discussions could take place with the Zaïrian authorities. Based on such an interpretation, I could support the proposed decision.

Ms. Lissakers commented that she could support the staff recommendation for the Board to consider the Managing Director's complaint on suspension of Zaïre's voting rights on May 18, 1994.

Consistent with the positions that had been taken by Directors at the previous discussion, the proposed decision granted Zaïre a substantial window of opportunity in which it could resume cooperation with the Fund and set its economy on the right track, Ms. Lissakers noted. Her authorities recognized the uncertain political situation in Zaïre, and, like Mr. Autheman, they hoped that the crisis would soon be resolved. They would certainly support every effort in that direction but, meanwhile, the economy was continuing to deteriorate and Zaïre's arrears to the Fund and other creditors continued to mount.

The staff report for the next Article IV consultation with Zaïre was expected to be available to the Board in time for the May 18 discussion, which should assist the Board in its deliberations, Ms. Lissakers said. It should be stressed, however, that the Article IV consultation and the consideration of suspension of voting rights were not directly linked. Delays in completing the Article IV consultation would not be an excuse for delaying Board consideration of the Managing Director's complaint, particularly given the lengthy interval that had been granted since the previous Board discussion in December 1993.

As on previous occasions, the authorities in Zaïre should be urged to take corrective actions as soon as possible to restore effective economic policies and to resume cooperation with the Fund, Ms. Lissakers stated. She expected the Fund staff to make every effort to work with the Zaïrian authorities in order to achieve that goal. In the meantime, her authorities would support efforts to bring an end to the political impasse in Zaïre.

Mr. Moss made the following statement:

To avoid prolonging the current discussion, I will intervene very briefly on Zaïre's overdue obligations to the Fund. My authorities recognize that the staff is seeking to be flexible in proposing a date for the Board's substantive consideration of the Managing Director's complaint about Zaïre's arrears and, therefore, they can go along with the proposed date of May 18, 1994.

I would like to point out that although an Article IV consultation is not a prerequisite for the May 18 discussion, my authorities would find it difficult--in the absence of any substantive documentation on the country's economic situation and outlook--to determine what kind of policy stance from the Zaïrian authorities could be considered cooperative. I understand that the staff is soon expected to travel to Kinshasa, which should provide ample time for the circulation of a staff paper well before the May 18 meeting. However, recent Zaïrian political developments, with their implications for policymakers, including the replacement of the Governor of the Fund for Zaïre, could cause some slippage in the proposed schedule. I hope this is not the prelude to another postponement of Zaïre's long overdue Article IV consultation.

From a more optimistic perspective, the most recent changes in Zaïre, together with the apparent resumption of at least some payments to the Fund, may herald the beginning of renewed cooperation between Zaïre and the Fund. While one swallow does not make a spring, I hope that spring will come soon not only to Washington D.C., but also to the relationship between the Fund and Zaïre.

Mr. Fukui recalled that, at the previous discussion, his chair had expressed the view that it would be appropriate to wait and see whether the Fund was able to have effective communication with the authorities of Zaïre before taking a decision. It was still not clear which of the competing Governments should be maintaining relations with the Fund. Moreover, the constitutional legitimacy of the administration communicating with the Fund was still not certain.

However, the staff report noted that the new authorities had made payments to the Fund since the previous meeting, Mr. Fukui said. Ironically, those payments served as an indication that the new authorities had accepted responsibility for clearing the arrears to the Fund. There-fore, setting aside the question of constitutional legitimacy, it would be reasonable for the Fund to send a clear signal to the authorities that were currently responding to the Fund's communications. Nevertheless, it should be stressed that the decision taken for the current discussion was not meant to have a bearing on the matter of constitutional legitimacy.

On that basis, his chair could support the proposed decision, Mr. Fukui commented. There was no reasonable excuse for postponing substantive consideration of the Managing Director's complaint, and the proposed decision provided the authorities another three months to demonstrate their willingness to resume cooperation with the Fund. During that time, a staff mission was expected to visit Zaïre. He hoped that the staff would have a constructive dialogue with the authorities during the next Article IV mission.

Mr. Dorrington noted that an argument could be made that the proposed date for the consideration of Zaïre's suspension represented some unnecessary delay. It was clearly important for the Board to have as much information as possible on Zaïre before it began its substantive consideration of suspension of voting rights. The Fund should search for any reason to give Zaïre the benefit of the doubt, but if that could not be found, the Fund should be prepared to act. His authorities considered that, in the particular circumstances of Zaïre, it would be appropriate to discuss the suspension of voting rights three months after the issuance of the Managing Director's complaint, i.e., when the staff report for the Article IV consultation would be available.

The Zaïrian authorities should be urged to follow the advice that had already been given by the staff as well as the advice that would likely be underscored during the Article IV mission, Mr. Dorrington commented. Scheduling the next discussion for May 18, 1994 would provide the authorities with an opportunity to cooperate with the Fund and to begin the adoption of appropriate policies. He hoped that the authorities would take full advantage of that opportunity.

Mr. Dlamini made the following statement:

Zaïre continues to face a very difficult political and economic situation, mainly owing to the existence of two competing parties seeking control of the Government and the virtual collapse of copper mining, which is the backbone of the economy. This grave situation has crippled the country's capacity to respond adequately to the demands of the Fund. Zaïre, which was once one of Africa's vibrant economies, is a nation for which the accumulation of arrears on wages and salaries to public servants has become a regular feature. In the circumstances, I can imagine how difficult it must have been for Zaïre to make two payments amounting to SDR 2.5 million since the previous discussion. This is indeed a significant improvement of its payments record over the preceding ten-month period, during which Zaïre was able to make only one payment of SDR 1 million as a tangible manifestation of its willingness to improve cooperation with the Fund in finding a solution to the arrears problem.

At the previous discussion, this chair did not support the decision calling for the initiation of procedures that could lead to the suspension of Zaïre's voting and related rights, because the gravity of the circumstances facing Zaïre warranted exceptional consideration by the Fund.

The political and economic situation in Zaïre continues to make it virtually impossible for the country to maintain normal economic relations with the rest of the world. Zaïre is in its greatest hour of need and deserves sympathy and support from the international community. In that respect, the Fund should postpone taking any unfavorable decision with respect to Zaïre, at least until the political situation becomes clearer, in order to allow Zaïre to take concrete actions both in the area of policies and payments.

Mrs. Wagenhoefer said that she could go along with the proposal to place the complaint of the Managing Director on the agenda of the Executive Board on May 18, 1994. That proposal would give the Zaïrian authorities reasonable notice, and would allow sufficient time for the staff to prepare a report on the next Article IV consultation, which could be taken up by the Board for the same discussion.

Ms. Laframboise stated that, like Mr. Fukui, she welcomed the payments that had been made to the Fund by Zaïre since the previous discussion. She agreed with other speakers that the Zaïrian authorities should be given some time to demonstrate their willingness to resume cooperation with the Fund before the Board took up the Managing Director's complaint for substantive consideration. Therefore, she could support the proposed decision. She looked forward to the next Article IV consultation with Zaïre.

Mr. Kaeser commented that his chair supported the proposed decision to place the complaint with respect to the suspension of Zaïre's voting rights on the agenda of the Board for substantive consideration on May 18, 1994.

Since the previous discussion, Zaïre's outstanding obligations to the Fund had further increased, Mr. Kaeser noted. The Fund had given sufficient warning to the Zaïrian authorities that, unless they complied in meeting their obligations to the Fund and undertook badly needed reforms, the suspension of Zaïre's voting rights would have to be considered. It was time to increase pressure on Zaïre. By setting the date proposed, Zaïre would be given ample time to adopt appropriate policies and to resume payments of overdue obligations to the Fund. He sincerely hoped that Zaïre would do so.

Mr. Yang said that his authorities were deeply concerned about the worsening economic situation in Zaïre. The Zaïrian authorities were making efforts to cooperate with the Fund, as demonstrated by their two payments totaling SDR 2.5 million since the previous discussion in December 1993. While recognizing that the authorities made those two payments in the face of tremendous economic difficulties, he urged them to redouble their efforts for closer cooperation with the Fund.

As the staff was expected to conduct discussions with the Zaïrian authorities in February 1994 on the next Article IV consultation, it would be appropriate for the Board to consider the Managing Director's complaint when the staff report was available, Mr. Yang considered. He could support the draft decision.

The staff representative from the African Department noted that a staff team planned to visit Kinshasa as soon as the proposed mission was approved by the new Governor of the Bank of Zaïre. The staff expected that such a mission could take place before the end of February 1994.

The Executive Board then took the following decision:

> The complaint of the Managing Director dated January 18, 1994 in EBS/94/7 (1/19/94) regarding Zaïre's persistent failure to fulfill its obligations to the Fund is noted. The Executive Board decides that the complaint shall be placed on the agenda of the Executive Board for consideration on May 18, 1994. Zaïre shall be informed by rapid means of communication of this matter and of its right to present its views, both orally and in writing.

Decision No. 10585-(94/11), adopted
February 14, 1994

4. ZIMBABWE - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT; REVIEW UNDER EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

Executive Directors considered Zimbabwe's request for the second annual arrangement under the enhanced structural adjustment facility (EBS/94/5, 1/18/94; Cor. 1, 2/9/94; Sup. 1, 1/24/94; and Cor. 1 to Sup. 1, 2/9/94). They also had before them a policy framework paper for 1994-96 (EBD/94/14, 1/25/94).

The staff representative from the African Department made the following statement:

> This statement updates the staff paper on Zimbabwe's request for the second annual enhanced structural adjustment and the review under the extended arrangement. The most recent information indicates that the Reserve Bank's net domestic assets continued to be larger than envisaged, Z$2,986 million as of January 28, 1994, compared with a program ceiling of Z$2,600 million established for end-March 1994. Other economic and financial developments have remained broadly on track.
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> In response to the developments in the net domestic assets of the Reserve Bank, and in order to contain domestic credit expansion, the Zimbabwean authorities took several measures in early February 1994: the reserve requirement for deposit money banks was raised by 1 percentage point to 13.5 percent; Reserve Bank bills amounting to Z$300 million--equivalent to 3.6 percent of the end-1993 deposit base of the deposit money banks--were issued to banks to absorb excess liquidity; and access of public enterprises to Reserve Bank credit has been further tightened. The authorities reaffirmed their intention to monitor monetary developments closely and to pursue an adequately tight monetary policy to contain inflationary and balance of payments pressures. As a result, the authorities fully expect to meet end-March 1994 performance criteria. Throughout the recent period, interest rates have remained significantly positive in real terms.

Preliminary data indicate that the total revenue and expenditure outcome for the first half of the 1993/94 financial year was on target. The overall budget deficit, excluding grants, at Z$2.1 billion, was as projected under the program. However, reflecting a shortfall in disbursement of foreign loans and prepayment of some government debt obligations, the Government's recourse to domestic borrowing exceeded the program estimate for end-December 1993. Total domestic financing was Z$2 billion, compared with a program projection of Z$1.6 billion. The shortfall in external financing, largely owing to delayed disbursements of World Bank commitments, was attributable to documentation problems, rather than to policy related difficulties. The foreign financing shortfall is expected to be largely temporary as some of the disbursements in question were made in January. Under the program, the authorities are committed to putting in place fiscal measures to compensate for any lasting shortfall in external financing, so as to ensure achievement of the budgetary objectives. In late January 1994, the World Bank released, as expected under the program, US$30 million of the first tranche of the Structural Adjustment Credit II, equivalent to US$125 million, approved in June 1993.

Gross international reserves amounted to US$560 million as of end-January 1994; net international reserves stood at US$34 million, compared with a floor on net international reserves of US$27 million for end-March 1994. Delays in the repatriation of export receipts and a buildup of foreign currency deposits at the commercial banks in the initial phase of the exchange reform are expected to be reversed as exporters gain confidence in the system. The new monetary policy stance and efforts to reverse the shortfall in foreign financing are expected to support the attainment of the reserve targets of the program.

The exchange market has been remarkably stable since the introduction of the exchange and trade reforms and the 17.1 percent devaluation of the Zimbabwean dollar on January 1, 1994. The official rate has remained at about Z$8.1 per $US1, and the market rate applicable to foreign currency account transactions at about Z$8.5 per $US1, with a spread between the two rates of about 5 percent. This spread is narrower than envisaged by the authorities for this early stage of the exchange market reforms. Also in this period, the rate of utilization of ERS entitlements has been very modest.

Mr. Dlamini made the following statement:

My Zimbabwean authorities are in broad agreement with the focus of the staff paper, which provides a detailed reflection of the medium-term economic agenda. They also appreciate the active role played by the Fund in catalyzing external assistance at the consultative group meeting held in December 1993.

The request for a second-year arrangement supported by the EFF and the ESAF is an indication that the authorities remain fully committed to the path of economic reform. Already, there are some positive results. The rate of inflation has fallen sharply, economic activity has rebounded and foreign exchange reserves have increased. It is expected that the decline in interest rates, coupled with the deregulation of investment, trade liberalization and price decontrol will strengthen the recovery. Real GDP growth is projected to more than double in 1994 to 4.4 percent.

Meanwhile, important steps have been taken toward reforming the public enterprises. Monopoly status of a number of these enterprises have been removed, the majority are operating under management contracts and price adjustments have been effected. Budgetary subsidies to the country's staple foods have also been abolished.

The drought-induced recession, however, slowed down the implementation of certain policies, with adverse consequences for the budget. For instance, it was not feasible, in the wake of mass labor retrenchments in the private sector and erosion of per capita income, for the authorities to meet their target on civil service retrenchment. There were also expenditure overruns owing to drought relief and transfer payments to public enterprises, including the Grain Marketing Board (GMB), which incurred losses on stocks of imported yellow maize, while offering higher producer prices to encourage production and early delivery of maize. Several other public enterprises were affected by lower domestic demand stemming from the recession.

These developments contributed to the nonobservance of a number of quantitative and structural performance criteria for which the authorities are requesting waivers. They are also requesting a waiver on the performance criterion related to the expansion of the Open General Import License, since they had to emphasize export retention in the face of a deterioration in the terms of trade.

The proposed program, which covers the period October 1993-September 1994, has three main pillars: fiscal consolidation; firm monetary policy; and a unified and market determined exchange rate. The authorities are aware that expenditure cuts are the key to bringing about a further deceleration of inflation and a faster growth of the economy. Public enterprise reform remains the centerpiece to expenditure reduction, which will be carried out in the context of a comprehensive plan that was approved toward the end of 1993. Most of these enterprises will be converted to private companies, requiring no further government assistance. Private sector participation has already been invited, including for the steel company which imposes the highest burden on the central government budget. Those remaining will be downsized and limited to well-defined core activities, and greater autonomy is being granted to management on matters of labor and pricing.

The retrenchment of the civil service is being accelerated, including the downsizing of the army. Although there will be increased expenditures for health and education, cost recovery measures have been put in place in these sectors beginning in January this year. Improved procedures are being developed, including computerization, that would facilitate the monthly monitoring of government expenditures.

The revenue base has been expanded, with the inclusion of taxation of various services. Other discretionary revenue-raising measures have also been taken, including the increase in customs duty on certain items. The objective is to reduce the budget deficit to 5.8 percent of GDP from 11.2 percent in 1992/93, which would represent a substantial adjustment effort. Meanwhile, the authorities are taking steps to reduce delays in the disbursement of donor assistance.

To preserve the gains achieved on the inflation front, the tight liquidity conditions will prevail as evidenced by the measures taken by the Reserve Bank in February, which include an upward adjustment in the reserve ratio. Interest rates will remain positive and the remaining controls removed. Important structural reforms in the financial sector will take place with the introduction of a new banking legislation during the course of the year. These changes will intensify competition in the financial sector and strengthen supervision.

The authorities are taking steps to improve external sector viability, against the background of a rising debt burden. In this connection, they have introduced further reforms to the exchange system, beginning January 1994, which increase the access of exporters to foreign exchange. The reforms also included a substantial depreciation of the exchange rate and the relaxation of regulations on dividends remittance and capital repatriation. The experience so far with these measures points to a smooth and stable transition. The objective of the authorities is the achievement of a unified and market exchange system before the end of 1994 within an environment of exchange rate stability and export-led growth. In addition, they will pursue a policy of low labor costs and the further deepening of competition to enhance productivity and the competitiveness of the country.

Maintenance of social stability is crucial to the successful implementation of economic reforms. In this regard, the authorities have undertaken to vigorously implement social projects under the Social Dimensions of Adjustment Fund and to reduce unemployment through the promotion of small-scale businesses.

Mr. Dorrington made the following statement:

We are being asked today to review recent performance under Zimbabwe's enhanced structural adjustment arrangement and its extended arrangement and, in that context, to endorse the program for the next year. While in some respects performance has been creditable, we cannot ignore the fact that a number of performance criteria have been breached.

The previous program review in May 1993 was overshadowed by the continuing effects of the devastating drought. While there was some sympathy with the reasons for the missed target, even though they were certainly not all exogenous, many Directors stressed the importance of returning to the original path of adjustment. I had hoped that, with the effects of the drought wearing off, management of the economy would have become less difficult, and the authorities would have been able to meet the program targets in full. Regrettably, that has not been the case.

Since the beginning of the program, the authorities have on average met only half of the performance criteria and benchmarks. This is clearly unsatisfactory: it means that either the program targets are being misspecified; the program design does not make adequate provision for possible shocks; or program implementation needs to be improved. Possibly a combination of all of the above are responsible. They all give cause for concern.

Let me explore these concerns. The program had assumed a greater rebound in economic growth after the drought than has in fact materialized. Weaker than expected private sector activity was due in part to the necessary monetary squeeze and in part to a shortfall in export revenues resulting from the sharp fall in tobacco prices. The latter contributed to a fall in the terms of trade in 1993 of 3.7 percent, rather than the rise of 5.3 percent forecast by the staff in May.

This is bound to raise questions about the realism of growth and balance of payments forecasts for the future. In particular, the likely impact of foreign exchange market liberalization does not appear to be reflected in the conservative projections of import growth. At the same time, any export revenue forecast must be vulnerable in view of the dependence on commodity exports and on uncertain developments in South Africa, a major trading partner. Program design needs to take into account this vulnerability to external shocks.

With respect to program implementation, there have been marked shortcomings in two areas which cannot be attributed to external shocks: the level of parastatal losses, and the rate of civil service retrenchment. The benchmark for reducing civil service numbers was missed for both December 1992 and June 1993. The performance criterion for government domestic borrowing has been missed on every occasion: the losses of parastatals have been a major cause of this.

The staff paper notes that failure to meet the civil service retrenchment target was owing to government concerns about unemployment and social disruption. However valid these concerns, they are not factors that were unknown when the authorities agreed to the targets.

Lack of progress in these areas led to failure to meet budget deficit targets by a wide margin. This, in turn, has made it difficult to meet the monetary targets, despite a strong monetary squeeze. Indeed, given the fiscal slippage, the performance of the monetary authorities has been very creditable. They have achieved a welcome reduction in the rate of inflation, albeit at the cost of making financial conditions very difficult for the private sector.

Thus, stronger control of the fiscal position of civil service and parastatal sector is not only a stabilization issue, but also a structural issue. It is vital that the private sector be enabled to expand, in order to provide a sustainable source of employment for Zimbabwe's growing population. At present, the public sector continues to crowd out private investment and to dominate too many domestic markets.

Reducing losses in the parastatals is thus essential. In many cases, this could be achieved by increasing prices in monopoly markets; but this merely passes on the burden to the private sector in another form. Therefore, the authorities need to take strong measures to improve the operating efficiency of these enterprises. I welcome the measures proposed for the coming year to create clearer boundaries between state enterprises and government, to make transfers more transparent and less automatic, and to increase private participation. These will provide a framework for pursuing greater operating efficiency.

I urge the authorities to consider carefully whether economic development is best served by continuing public involvement in so many industries. Zimbabwe is fortunate in having one of the more developed capital markets in the region. This provides scope for bringing in greater private capital in these industries. But it is much less likely to be forthcoming if the Government insists on maintaining overall control.

I note the expectation that foreign direct investment will increase. This is important for future growth. So too is expansion of indigenous private sector activity; I am aware of the importance the Government attaches to facilitating the full participation of all sections of Zimbabwean society in economic development. This is obviously a desirable objective, but I urge the authorities to design policies to encourage indigenous economic activity carefully so as not to deter foreign investment. Zimbabwe needs both.

The authorities are to be congratulated for the very good progress in liberalizing price setting and foreign exchange allocation. In particular, I welcome the authorities' intention to unify the exchange rate by end 1994. I encourage the Government to remove the remaining controls on current and capital payments, as a further incentive to foreign investment.

I also welcome the authorities' intention to demobilize part of the military. The benefits from this will accrue mainly in the medium term, but I hope that Zimbabwe will be able to design the program so as to minimize the social and financial costs of the process. The World Bank has recently completed a review of experience with demobilization programs, which suggests that expensive retraining programs may not be cost effective. I am sure the authorities will draw on this study, as well as more directly on the experiences of other countries, in designing their program.

The targets for this year could be more ambitious: they will not recoup the slippages that have already occurred under the program.

In order to ensure that programmed budget savings are achieved, the target for civil service retrenchment should be expressed in terms of payroll cost, or numbers of staff, rather than--or perhaps as well as--the number of positions, since abolition of junior posts will not save much, and abolition of unfilled posts will save nothing.

Given the importance of parastatal losses to both stabilization and adjustment, I wonder whether the existing data on their financial position are sufficiently accurate. Is the target specified in cash or accrual terms? Will the changes to the structure of the parastatal sector affect the definition of operating losses? How does the target take account of this? I would have liked to see the structural benchmark place more emphasis on reducing operating costs, rather than simply increasing net revenue. Is there a need for technical assistance to help the authorities improve their monitoring and control?

In the light of the uncertainties surrounding program implementation, the authorities should adopt a prudent approach to economic management, to ensure that slippages in any area are offset by other actions to allow the targets to be achieved. One step in this direction would be to take a more cautious approach to tax reform, to only grant tax reductions once it is clear that the overall deficit is on target.

In conclusion, I can support the proposed decisions, including the waivers requested. There have been some serious slippages, but also notable progress in some areas, and the staff has provided encouraging news on very necessary recent progress, in particular on the fiscal side. There is scope for improved program design, but the key problem is implementation. This simply must improve. I note all the authorities' good intentions, but action is overdue on a number of old intentions. I urge close monitoring of implementation of this year's program; if slippages recur, I would expect to see timely strong corrective action taken to remain within targets.

Mr. Havrylyshyn made the following statement:

I can support the staff proposal to approve the second annual enhanced structural adjustment arrangements and the purchases under the EFF, including the request for waivers. However, I do so with mixed feelings with respect to both the design of the program and the approach of the authorities. My reservations could not have been described better than by Mr. Dorrington. As I fully endorse his remarks, I will make a few brief points.

Last year I supported the requested waivers, because despite shortcomings in performance, I had confidence in the authorities' commitment to the program. For the current discussion, despite my awareness and understanding of the persistent difficulties that arose from the severe drought, I am afraid that this confidence is eroding. It appears that "action is overdue on a number of old intentions" as Mr. Dorrington noted, raising doubts about implementation of proposed measures.

This seems to be the case with respect to fiscal policy. It is regrettable that on the expenditure side overruns did occur that were not directly related to the drought.

Another worry is that civil service retrenchments are behind schedule. I agree with Mr. Dorrington that, if there were concerns about unemployment and social disruption, they should have been taken into account when the commitment to the targets was made.

Finally, I am somewhat puzzled about whether the maize subsidy mechanism has indeed been completely eliminated as was announced at the previous review. This is not obvious from the staff paper, which states that remaining administered producer prices for maize--among other things--will be managed more flexibly starting April 1994. Does flexibility include both profits and losses? I wonder whether the staff could explain this more fully.

Mr. Fontaine made the following statement:

Zimbabwe has made significant, and finally, rather rapid progress, since embarking on the path of economic reform and adjustment in 1991. It is all the more remarkable that this progress has been achieved against the background of a tremendous drought.

However, the progress made thus far has been uneven. Very positive strides have been achieved in implementing a number of economic reforms directed at deregulating and liberalizing the economy. These reforms are certainly necessary to accelerate growth, but these policies ought to have been supplemented by a well-balanced macroeconomic policy mix and, in this respect, policy implementation has been less satisfactory.

As pointed out by the staff, the stabilization effort has relied solely on monetary policy. Success in reducing the rate of inflation has been unquestionable, and monetary policy has helped to reduce balance of payment pressures.

At the same time, growth performance has been disappointing: while the agricultural sector has rebounded more quickly than expected, the overall growth rate has remained weak. The tighter than needed monetary policy stance of the reserve bank and the resulting high real interest rates have most certainly contributed to this outcome.

Conversely, fiscal policy has not been successful, as efforts to compensate, at least partially, for the unexpected budgetary emergency expenditures have not been decisively undertaken. Consequently, the fiscal deficit has increased to an unsustainable level of 11 percent of GDP. Together with a shortfall in foreign assistance disbursements, this deficit has led to the nonobservance of performance criteria at the end of June 1993 on the net domestic borrowing of the Central Government.

I welcome the fact that the authorities are taking the needed corrective actions. The program, following the revision of the 1993/94 budget, is now correctly focused on the reduction of the overall deficit. From the staff's opening statement, I note with satisfaction that the overall budget deficit for the first half of this financial year was on target.

Adherence to performance criteria and benchmarks related to fiscal policy will be the most important parameter of the success of the 1993-94 program. I welcome the authorities' commitment to take further measures to compensate for any unforeseen slippages, including any shortfalls in external financing. This will be a prerequisite for satisfying the demand for credit from the private sector, which is expected to generate future growth.

The core of the program should rest on the Government's ability to reduce overall public expenditures while increasing, as is its commendable intention, the budgetary allocation for social services. In addition to a strengthening of expenditure procedures and controls, this would require that the civil service retrenchment program and the public enterprise reform be addressed more decisively.

The wage bill, which will still represent a large share of GDP, should be firmly reduced. The difficulties experienced last year in trying to reach the program's target for the civil service retrenchment indicate that the authorities will have to demonstrate the greatest determination in this area. Together with the consequences of the restructuring of parastatals and the demobilization program, these retrenchment measures could prove difficult to achieve in the context of widespread urban unemployment without a strengthening of the social dimension of the adjustment program, as well as further actions to stimulate small domestic business. The development of small businesses will be critical not only to promote future growth, but also to secure political and economic support for the present adjustment policy.

I welcome the authorities' action plan for the parastatals, which rests on the principles of corporatization and enforcement of hard budgetary constraints. Attention should be paid, in this framework, to avoid a repeated occurrence of large increases in administered prices and tariffs, which merely served to cover increasing costs, thus putting additional strains on the private sector. I wonder whether a more proactive stance regarding privatization, including with respect to utilities, would have been appropriate.

Reduction in military outlays should contribute to fiscal consolidation. Cuts in this area are envisaged though a demobilization program, but this program is not expected to have any budgetary impact before 1997. While the genuine problems created by such a program cannot be ignored, improvements in the regional security situation create conditions for a sustained reduction in national defense expenditures, which account for about 4 percent of GDP.

The success of the recent consultative group meeting should encourage the authorities to pursue the adjustment program. The pledges of external assistance have closed the financing gap for 1994, and adherence to the adjustment program will certainly help to attract further donor support in 1995, before external viability is attained.

This prospect is extremely encouraging, but Zimbabwe's balance of payments has proved to be vulnerable to external shocks. Therefore, financial policies should continue to be firm, especially as the program includes substantial headway toward a complete liberalization of the trade and exchange system.

I commend the authorities for their excellent external debt payment record, against the background of an increasing debt-service ratio.

Zimbabwe's three-year parallel arrangement supported by the ESAF and the EFF is rather unusual, but this kind of agreement could prove to be appropriate for other countries that are eligible to use ESAF resources and that require a large degree of Fund support, while benefiting from relatively higher levels of GDP per capita and lower debt-service ratios than the average for ESAF eligible countries.

With these comments, I support the proposed decisions.

Ms. Bessone Basto made the following statement:

Despite extremely difficult conditions, hampering the growth of the economy and the progress of reforms, Zimbabwe performed relatively well under the 1992/93 program. The recovery of the agricultural sector occurred shortly after the drought. The inflation rate was reduced through a tight monetary policy targeted mainly at keeping interest rates significantly positive in real terms, and the Government implemented important economic reforms aimed at trade liberalization, investment deregulation, and price decontrol. GDP grew slightly in 1993 at a rate of 2 percent, after a decline of 8 percent in 1992, when the low level of domestic demand and the tight monetary policy contributed to the weakness of the economic activity.

While I welcome the progress achieved by Zimbabwe in the past year, some concerns remain with respect to the necessary steps ahead. In the present situation, Zimbabwe exhibits some slack and delays in the achievement of previously formulated objectives.

Some of the performance criteria, both quantitative targets and structural reform measures, were not observed. Moreover, the budget deficit remains a cause for concern. Although--and in spite of reduced economic activity--revenues were higher than expected, owing to more aggressive tax collection, the growth of expenditures, not all related to the drought, contributed to the increase of the deficit. In addition, reforms directed toward the civil service retrenchment and the restructuring of public enterprises, which incurred significant losses over the past year, still need improving.

The measures being implemented under the second-year parallel program supported by the ESAF and the EFF, which is characterized by restrained monetary and fiscal policies, deregulation of the economy and the reliance on the private sector as an engine of future growth, seem adequate to attain the performance criteria established to support the 1993/94 program and to enhance solid and sustained growth in the future. Nevertheless, it is important that a significant effort be made to rationalize the size of the Government in the economy and reduce its deficit so that the country does not have to rely exclusively on monetary policy to control the rate of inflation, with the negative consequences this could have on investment.

Since the abolition of some restrictions in foreign payments and transfers may make the national currency more vulnerable to market pressures, monetary policy should focus on real exchange rate stability, rather than on the nominal exchange rate, in order to avoid a loss in export competitiveness.

I welcome the measures to encourage foreign investment. To reduce the budget deficit, several revenue-enhancing and expenditure-reducing measures have already been implemented. However, to minimize the adverse effects of a tight fiscal policy on economic activity, the effort to reduce the budget deficit should be oriented primarily toward expenditure cuts rather than tax increases.

Within the scope of the civil service reform, the authorities' goal is to achieve the rationalization of government functions through the abolition of some posts and the demobilization of the armed forces. The reforms of public enterprises will be oriented toward making improvements in efficiency, downsizing some enterprises, and achieving flexibility in pricing and greater managerial autonomy. The future privatization of some public services and enterprises could also contribute to the rationalization of the public sector. Because the present poor labor market conditions are making increasingly difficult the retrenchment of the civil service, I welcome the implementation of retraining programs. In this respect, I agree with the concerns expressed by previous speakers about the failure to meet the target for reducing the size of the civil service.

As Zimbabwe performed relatively well in the first part of the Fund-supported program, sound economic policies are proposed under the second annual enhanced structural adjustment arrangement, and the economic projections indicate external viability in the near future, I support the request for the second annual enhanced structural adjustment arrangement and for the purchase under the second year of the extended arrangement.

Ms. Lissakers made the following statement:

Overall, Zimbabwe's progress under the program over the past year has been somewhat uneven. Monetary management was a bright spot, and needed reforms were advanced in a number of structural areas. Nevertheless, like Mr. Dorrington, we are somewhat disappointed by Zimbabwe's failure to get back on the program path following the midterm review in May 1993.

The mix of macroeconomic policy is lopsided and unsustainable. Fiscal performance and the achievement of program objectives have been undermined by the lack of progress on privatization and civil service reform. Consequently, an excessive burden has been placed on monetary policy, at the expense of credit to the private sector.

There is clearly a pressing need to redress this policy imbalance through further reductions in the still very large fiscal deficit. The objective of reducing the deficit to 5.8 percent of GDP is encouraging, and we welcome the various commitments the authorities have made with respect to the fiscal area, including possible contingency measures. However, the figures for July to December provide reason for hope that these measures will not be needed. However, risks remain in the form of projections that may be overly optimistic and potential shortfalls exist in external assistance. In addition, concerns remain about whether the strategy for dealing with state enterprises is sufficiently ambitious and whether the civil service reform is moving ahead as fast as agreed--or as fast as the fiscal situation would demand.

The authorities should be commended for their monetary policy performance thus far, especially given the heavy demands for credit to the public sector. Like the staff, we strongly hope that the monetary components of the program can be brought back in line by end-March; we also look forward to early passage of the revised financial sector legislation. If there is a better balance on the fiscal side, perhaps there will be more room for easing monetary policy, which could have beneficial impacts, particularly on private investment and the rate of growth.

In addition to progress on the fiscal side, there is the need for further progress in implementing structural reforms. While progress has been made over the past year, it has been inadequate to deregulate the economy and spur domestic and foreign investment, especially in view of regional developments. In particular, the staff has emphasized the importance of reducing the role of the public sector in the economy so that sustainable higher rates of growth can ensue. We wonder whether the program goes far enough with respect to this restructuring, particularly in the reform of enterprises. We share the concerns expressed by Mr. Dorrington about the fact that the revised targets do not recover past shortfalls. Moreover, the strategy currently embodied in this program is not adequate. While we welcome the various measures announced in November 1993, exclusive reliance on restructuring and cost containment, even with limited private equity participation, does not appear sufficient to eliminate the sizeable fiscal drain currently posed by these enterprises.

More broadly speaking, continued large-scale government involvement in these enterprises appears to run counter to the pressing need to boost the role of the private sector to spur private investment, and encourage employment-creating activities. While acknowledging that political impediments exist, we would strongly prefer to see the authorities adopt an approach similar to that under way in a number of the economies in transition, such as Argentina. Government involvement in all enterprises should be reviewed with a general bias toward rapid and full privatization of viable enterprises in the near term; nonviable enterprises should be liquidated. Compared with the economies in transition, Zimbabwe has an added advantage of a vigorous emerging equity market that should facilitate the privatization process.

The Government must recognize the need to encourage private investment from both domestic and foreign sources in order to take full advantage of Zimbabwe's many strong attributes, including a low-cost, productive, and educated labor force, and in light of the new challenges in the rapidly changing southern African economic and political situation. The program contains a number of helpful measures, but if policies are not adjusted swiftly to reflect new realities, there is a danger that significant opportunities could be lost as a result.

Apart from further macroeconomic stabilization, a major effort to deregulate and open the economy would appear to be in order to facilitate investment. In spite of a number of recent reforms, the investment regime still appears to be overly restrictive. In addition, the investment climate could be substantially improved through an early effort to unify the exchange rate, move to a market-determined exchange rate system, and lift the remaining restrictions on both capital and current account transactions. Finally, the Government needs to take care that its efforts to address social concerns and create economic opportunities for all its citizens, for example through land reform, are handled in a way that will not scare off the much-needed investment that ultimately will be the source for sustainable, broad-based, employment-creating growth.

The staff representative from the African Department noted that since the staff paper was circulated on January 18, 1994, the Parliament in Zimbabwe had passed enabling legislation permitting the Government to raise tariffs on a range of products. Thus far, the Government had not used that authority, except with respect to a tax on passenger motor vehicles. While the authorities considered that the recent enabling legislation was called for in the light of the liberalization of the exchange and trade system that became effective at the beginning of 1994, the staff considered the possibility of increased tariffs a cause for concern. Nevertheless, the Government was committed to reviewing the current system of tariffs by the beginning of 1994/95 with a view to lowering tax rates and to reducing the disparities among tax rates for various items.

In the light of the impact of the drought and the recession, there had been a need to scale down the original growth projection of 7 percent to about 2 percent, the staff representative said.

In assessing the balance of payments projections, it was important to distinguish between drought-related imports and non-drought-related imports, the staff representative stated. While the unprecedented level of food imports necessitated by the drought would drop sharply in the period ahead, non-drought-related imports were projected to reverse by 31 percent in 1994. In subsequent years, the total volume of imports was expected to rise in line with--or even to exceed--the growth of real GDP. In light of the revised growth projections, the staff projections on the balance of payments were realistic with respect to both the short term and the longer term. In fact, the staff had based its projections for exports on conservative assumptions, given the recent developments concerning the terms of trade and tobacco prices on the world market.

While developments in South Africa had traditionally had a significant impact on Zimbabwe, the program did not rely on improvements in the situation of South Africa, the staff representative commented. In that respect, it should be noted that exports to South Africa represented only about 10 percent of total Zimbabwean exports.

The overall objectives of the civil service reform remained intact for the three-year program period, the staff representative continued. It was important to note that the original program called for a 25 percent reduction in civil service positions outside the fields of health and education. Toward that end, a number of vacant civil service positions had been eliminated. Nevertheless, of the 11,339 positions abolished by the end of October 1993, 5,000 staff had actually been retrenched. In that respect, the reform of the civil service that had taken place so far was meaningful, even though it fell short of the program target. As there were no longer many vacant positions in the civil service, future reductions in the number of posts would be in net terms and, thus, would be reflected in the outcome for the civil service payroll. As the retrenchment program covered all grades of the civil service, the burden of adjustment was not likely to fall unevenly on staff in lower grades.

As Directors had noted, there were serious problems related to the compilation of data on the public enterprises, the staff representative remarked. The Zimbabwean authorities could clearly benefit from technical assistance in that area. Perhaps the World Bank could provide some assistance to the authorities through the provision of a public sector management project that would include efforts to improve the collection of economic statistics. As the quantitative performance criterion related to the public enterprises had been expressed on an accrual bases prior to budget transfers, it was not affected by the structural changes expected in the public enterprise sector. However, as the program proceeded, there would be a possibility to adapt that target to changing circumstances, in particular the expected change in the legal status of the public enterprises, which was gearing toward opening up that sector to private sector participation. In that respect, it was important to note that the target related to the reduction of public enterprise losses covered only one aspect of the public enterprise reform program. The effort to promote greater competition in the economy would reduce the enterprises' ability to address losses merely through price increases. In the current circumstances, it was important to strike a balance in setting targets that would be both sufficiently ambitious and realistic.

The targets that had been established under the original program relating to the budget, the rate of inflation, and the elimination of public enterprise losses would be maintained over the balance of the three-year program period, the staff representative from the African Department said. While some time might be required to fully reverse the slippages that had occurred in the initial stages of the program, those targets were still expected to be met before the program expired. In light of the effects of the drought and the subsequent recession, it has been necessary to modify the program's original targets related to growth, investment, and the current account in order to reflect the lower than originally envisaged terms of trade.

Mr. Havrylyshyn noted that the staff paper indicated that the GMB would establish a maize pricing policy designed to limit any temporary trading loss to an amount consistent with the government budget. He wondered how the compensation for trade losses was to be carried out and how it would be financed.

The staff representative from the African Department recalled that the consumer subsidy related to maize had been phased out in 1992/93 under the first-year program supported by the ESAF and the EFF. In the crop year 1993/94, which started in April 1993, producer price guarantees had been provided to producers to stimulate the supply of grain. The implied subsidy was to be replaced in April 1994 by the price mechanism to be established by the GMB. As the current budget did not provide for such a subsidy, the authorities would need to take offsetting measures to finance any gap that arose between producer prices and the sales market prices. In that connection, however, it should be noted that, as the proposed pricing mechanism would be in effect in the first quarter of 1994/95--the final quarter of the proposed program year--the new budget to be presented to Parliament would need to include provision for such a temporary subsidy. The program to be supported by the ESAF and the EFF excluded the possibility of making such a subsidy permanent.

Mr. Dorrington considered that it would be extremely difficult to forecast the balance of payments outcome accurately. The program included some contingency mechanisms that could be used to offset deviations from the underlying assumptions related to the need for balance of payments support. It would have been useful to also include some contingency mechanisms to offset any deviations from the program assumptions related to commodity prices.

Although there were no longer many unfilled positions in the civil service in Zimbabwe, it would have been more appropriate to set benchmarks based on the total wage bill, rather than on the number of positions in the civil service, Mr. Dorrington suggested. He wondered what the rationale was for setting targets on the basis of numbers of positions in countries, such as Zimbabwe, where there were a number of vacant positions.

The staff representative from the Policy Development and Review Department responded that it would clearly be preferable to base performance criteria on the actual outcome of the government wage bill. However, in the case of Zimbabwe, the Government did not have the capacity to provide timely data on the wage bill. Therefore, the authorities had preferred to set a benchmark based on the number of positions in the civil service, which could be more easily monitored.

Mrs. Wagenhoefer made the following statement:

> Zimbabwe's economy seems to be recovering from the devastating drought that dominated the economy during the first year of the program supported by the ESAF. On the whole, the authorities' crisis management should be commended. However, the failure to fulfill at least five performance criteria or benchmarks is no mere blemish. In the light of the authorities' steadfast pursuit

of their "Economic Structural Adjustment Program"--to which there is no viable alternative--we are willing to give the authorities the benefit of the doubt and endorse the proposed decisions.

We agree with the staff that the future success of this program depends, to a large extent, on a thorough reform of the public sector, in particular a reduction of its claim on available economic resources. Rapid expansion of the public payroll in the 1980s exerted increasing pressure on Zimbabwe's macroeconomic savings, thereby, crowding out private investment. This development, together with strong population growth, has led to a situation in which only one out of every three school-leavers finds employment in the private formal economy. The resulting level of unemployment leads to an uncontrollable proliferation of the informal sector, which reduces the tax base and impedes the sort of economic development that seems desirable in the longer run. A substantial "brain drain" of labor, educated at high cost, into neighboring countries can also be observed.

According to a recent World Bank report, 40 percent of Zimbabwe's population was receiving free food from the Government at the end of 1992. I wonder whether this has added to the budget deficit, thereby, fueling inflation rates and hurting the poorest members of society.

I also wonder whether the staff could comment on the prospects for Zimbabwe of further regional economic integration in Southern Africa.

It would also be useful if the staff could explain the likely impact of the Land Acquisition Act on the agricultural base of Zimbabwe's economy.

Ms. Srejber made the following statement:

I concur with the staff and other speakers that there have been some encouraging developments in Zimbabwe during the first year of the program. I commend the authorities, especially for their tight monetary policy, which has been the main force behind the significant decrease in the rate of inflation, and for the good progress made in liberalizing the exchange and trade systems.

However, it is evident from the staff paper that the economy as a whole has remained weak, and not mainly because of the drought of 1991-92. Most worrisome is the fact that fiscal policy has failed to adequately support the stabilization objective. Several targets to contain expenditures were missed which, in turn, led to a heavy overrun in the domestic borrowing requirement of the Government, and a waiver under the extended arrangement is needed. According to the staff paper, the authorities have taken corrective measures, and the program for 1993/94 seems to be sufficient to achieve the new objectives.

I am in broad agreement with the staff appraisal, and I support the proposed decisions.

The major objective of the new program for 1993/94 is to achieve higher and more sustainable rates of economic growth by reducing the share of the public sector in the economy and encouraging private sector activity.

First, it is very important to find the right balance between a carefully managed monetary policy and economic activity. In the case of Zimbabwe, a firm monetary policy has been adopted to avoid volatility in the nominal exchange rate, and the target is to support a stable market-based exchange rate. Could the staff elaborate further on the exchange rate target; would, for example, a trend in the exchange rate be counteracted by changes in interest rates, or is the target to avoid excessive volatility without counteracting trends? According to Chart 4 of the staff paper, there seems to be a high stabilization in the nominal exchange rate following the depreciation, but a trend of appreciation in the real effective exchange rate, which may lead to problems for exports.

Second, as this chair indicated during the previous discussion on Zimbabwe, monetary policy cannot carry the whole burden of coming to grips with the rate of inflation. Fiscal policy and structural reforms also have to make important contributions to that cause.

Past experience in Zimbabwe has shown that it has been very hard to reduce the claim of the public sector on available economic resources. Therefore, I wonder whether the projection of a budget deficit of 5 percent of GDP is realistic compared with a deficit of 11.2 percent in fiscal year 1992/93. The authorities must more vigorously pursue the expenditure-reducing measures, including the rationalization of government functions. So far, the civil service retrenchment has not moved ahead as planned, and the new objectives are quite ambitious. At the same time, the burden of direct taxes remains very high, even after the planned reductions. Therefore, I wonder whether the fiscal policy stance provides enough incentives for private sector activity.

With respect to the medium-term outlook, the staff's balance of payments projections indicate that Zimbabwe should attain external viability by 1996. At the same time, a financing gap of $121 million remains for 1995. Could the staff comment on the prospects for closing the gap through additional financing or, even better, through the tightening of financial policies?

Mr. Yang made the following statement:

The authorities deserve to be commended for combating the drought problem successfully while achieving most of the programmed criteria and benchmarks under the program supported by the ESAF and the EFF. As Mr. Dlamini noted in his very helpful opening statement, the rate of inflation has fallen sharply, economic activity has rebounded, and foreign exchange reserves have increased. As I am in broad agreement with the staff appraisal, I will make only a few remarks.

First, as GDP is estimated to grow by only 2 percent in real terms in 1993--which is a marked improvement over the decline of 7.7 percent in 1992--I agree with the staff that, in spite of the considerable progress made, the economy on the whole is still weak in the wake of the drought. In order to address this issue and revitalize the economy, the authorities have laid out a comprehensive program for 1994, aimed at achieving real GDP growth of 4-5 percent, and the Government's medium-term objectives are geared toward fostering a stronger economic recovery. The authorities should be encouraged to implement the policy measures firmly to achieve these objectives.

Second, in connection with putting a spur to the economic expansion, the authorities are encouraging the private sector to play an increasing role in economic growth and have created the necessary macroeconomic environment for nurturing the private sector by various deregulations and liberalizing foreign trade and foreign exchange. In addition, they are committed to satisfying the credit needs of the private sector. However, it is worrying to note that interest rates in real terms were significantly positive last year. Inappropriately high interest rates, while attractive to depositors, discourage investors, thus adversely affecting economic activity, as noted by the staff. Therefore, as administrative controls are phased out, the authorities should ensure that the level of interest rates is not only in line with the tight monetary policy, but also conducive to economic development.

Third, we are pleased to note the authorities' strong determination to improve the fiscal position by implementing various pointed measures to enhance revenue and reduce expenditures. Experience shows that in circumstances, such as those prevailing in Zimbabwe, it is likely that more strenuous efforts will be required to ensure the successful implementation of expenditure-reduction measures. We hope that the authorities will give adequate attention to the need to reduce expenditure, especially at the present juncture, when civil service retrenchment, military demobilization, and public enterprise reform are all to be undertaken.

In conclusion, we support the proposed decisions, which will enable the authorities to proceed with the parallel programs.

Mr. Verjbitski made the following statement:

During the first year of the program, in the aftermath of a severe drought in 1992, Zimbabwe achieved a modest real GDP growth of about 2 percent and made substantial progress in liberalizing its trade and exchange systems, decontrolling almost all domestic prices, and sharply reducing the rate of inflation. In this context, the authorities' request for a second-year arrangement supported by the ESAF and the EFF is a welcome indication of their determination to continue economic reform. Taking into account Zimbabwe's exemplary debt-servicing record and the staff projections on its good prospects for attaining external viability by 1996, this chair can support the proposed decisions.

However, we share the concerns expressed by Mr. Dorrington about the requested waivers of performance criteria. I agree with the comments made by Mr. Dorrington and other Directors about the nonobservance of a number of key 1992/93 program benchmarks.

It is particularly worrisome that the authorities, in their efforts to reduce the rate of inflation last year, relied solely on monetary policy, failing to undertake the necessary fiscal tightening. Quite predictably, the results were mixed. Although the annual inflation rate was reduced from 46 percent at end-1992 to 19 percent in December 1993--which, in itself, is a significant achievement--the Central Government's budget deficit climbed from 7.6 percent to 11.2 percent of GDP. In the circumstances, the Reserve Bank of Zimbabwe was left with little, if any, room for maneuver in bringing down real interest rates. Real interest rates in Zimbabwe remain at prohibitively high levels, depressing domestic demand and forcing exporters to look for less expensive external financing.

Of course, some of the slippages in the implementation of Zimbabwe's program can be attributed to such adverse exogenous factors as a regrettable shortfall of some $95 million in programmed external financial assistance, a 35 percent decrease in export prices for tobacco, and a slower than expected recovery in regional economic activity. However, delays in implementing civil service retrenchment and introducing new financial sector legislation cannot be justified by these developments. Failure to commercialize parastatals and curtail their losses is also, in part, the result of mismanagement. Strong measures under the new program are fully warranted to ensure Zimbabwe's future compliance with the performance criterion for domestic borrowing by the public sector.

In this context, the measures that were taken earlier this month are commendable. I note from the staff paper and Mr. Dlamini's statement that the majority of public enterprises in Zimbabwe currently operate under management contracts. I wonder whether these contracts incorporate what is called in Russia "Volcker's approach", based on the recommendations to my authorities made by the former Chairman of the U.S. Federal Reserve. Under the approach, managers who cannot control costs and expect the Government to subsidize their enterprises should submit their resignations when they request more subsidies from the budget.

With respect to Zimbabwe's program for this year, I broadly agree with the staff appraisal and recommendations. I welcome the strengthening of the performance criterion related to the ceiling on the combined operating loss of major public enterprises through narrowing their number from ten to nine--by excluding the Zimbabwe Electricity Supply Authority (ZESA), which has recently turned in sizable profits. However, it is not clear why another profit-making parastatal--the National Oil Company--whose profits have been consistently higher than ZESA's, remains on the list of nine. I wonder whether the staff could explain this.

The most recent economic data provided by the staff seems to indicate that, in some areas, the targets for this year could be more ambitious. The spread between the official and market exchange rates is currently only 5 percent. Therefore, the unification of exchange rates could, perhaps, take place earlier and be made a benchmark for end-June 1994.

It would also be desirable to expedite the drafting and presentation to Parliament of a revised Reserve Bank Act. I hope that timely technical assistance by the Fund staff will help the Zimbabwean authorities avoid another slippage in meeting this important structural benchmark.

In conclusion, I commend the authorities for their commitment to keeping the program for this year on track and taking additional fiscal measures when necessary, both on the revenue and the expenditure sides, to compensate for any unforeseen slippages. I am confident that such an approach, coupled with more vigorous efforts to mobilize external financing, is the key to the success of Zimbabwe's economic adjustment.

With these comments, I support the proposed decisions.

Mr. Isataev made the following statement:

The economic adjustment and structural reform program that Zimbabwe undertook with the cooperation and support of the international lending institutions encountered enormous difficulties in 1991/92, owing to the continuing global recession and the unexpected food import expenditures required by the worst drought in living memory.

Despite the economic damage done by recession and drought, the authorities' strong commitment to the program enabled them to meet, or even exceed, several of the program's targets, especially in introducing free market prices for most goods and services and making further progress toward trade liberalization. Increasing the permitted export retention level from 5 percent in 1990 to 60 percent has increased the availability of foreign exchange for companies that, for decades, had endured a strict rationing system. We share the authorities' confidence that further increases in export retention and the recent abolition of preferential access to the central bank's foreign exchange for holders of an Open General Import License will make possible a changeover to a fully market-based system of foreign exchange allocation by the end of 1994.

These measures, together with the recent easing of curbs on the remittance of dividends to foreign shareholders, should also contribute to the creation of a more friendly climate for foreign investment. However, although there are signs that foreign investment is reviving, the present 30 percent capital gains tax continues to prevent the Zimbabwean stock market from becoming fully competitive with other regional stock exchanges, such as those in Botswana, Namibia, and Kenya. In this connection, I wonder what measures have been taken to date and what more the authorities intend to do in this area.

We welcome the authorities' plan to reduce the burden of the public sector on available economic resources. Efforts to reduce the fiscal deficit and manage public resources more efficiently have had almost no effect, largely because of the large public expenditures connected with the drought. At a time of tight monetary restraint, these unavoidable expenditures crowded out the private sector and led to a rise in interest rates, which has negatively affected investment and recovery in the private sector. In addition to increasing public enterprise efficiency and widening the participation of the private sector, the authorities are committed to putting hard limits on the size of the central government budget deficit.

Some phases of the effort to reduce the public deficit are especially worrisome: the planned massive civil service layoffs and the military demobilization program will add significantly to the rate of unemployment, which is already above 30 percent. I wonder whether the authorities' Social Dimensions of Adjustment program is capable of dealing with unemployment on such a scale? I would appreciate some additional information from the staff on the problem in general, and in particular its impact on unemployment in the agricultural sector following the recent tobacco price crises. Concerning the structural reformation of the agriculture sector, could the staff comment on the progress made with the land ownership reforms originally planned for 1992-93?

I support the proposed decisions.

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

Despite some regrettable slippages, the performance of Zimbabwe under the first-year program supported by the ESAF and the EFF has, on the whole, been encouraging. Fundamental reforms in the areas of deregulation, fiscal and monetary policies, and the liberalization of the exchange and trade system, have been put in place, and important progress is being made in reducing the rate of inflation and financial imbalances. These are commendable achievements, especially given the difficult circumstances still facing the authorities.

Overall, we are in broad agreement with the staff assessment of the Zimbabwean economy and with the policy recommendations for the second year of the program. We also agree with the staff that the economy remains weak, and there is a need to strengthen fiscal policy and to accelerate structural reforms, especially in the public enterprise sector. Therefore, we welcome the emphasis being placed on these two sectors in the program.

We are pleased to note the determination of the authorities to bring the fiscal deficit down significantly. In this respect, the program envisages almost halving the fiscal deficit from 11.2 percent of GDP in 1992/93 to 5.8 percent of GDP in 1993/94, resulting mostly from a reduction in current expenditure. This may appear to be an ambitious target, given past performance, but we agree with the authorities that it is achievable, as the factors that led to past slippages no longer exist, and the authorities have implemented a number of additional measures on both the revenue and expenditure sides. These measures appear to be effective, as the preliminary data for the first half of 1993/94 indicate that total revenues and expenditures are on target. Nevertheless, we join other speakers in encouraging the Zimbabwean authorities to maintain their efforts to reduce expenditure further, and we would underscore the need to strengthen public sector resource management and to increase public savings. In this respect, we agree with the staff that a more vigorous effort with regard to civil service retrenchment would be appropriate. A reduction of the fiscal deficit is needed to support the thrust of monetary policy, to bring down the rate of inflation further, and to stabilize the economy.

We also share the concerns expressed by the authorities abut higher levels of unemployment and the potential for social disturbance. As Mr. Dlamini pointed out in his opening statement, maintenance of social stability is crucial to the successful implementation of economic reforms. In this respect, we commend the authorities for implementing social projects that have helped to maintain social stability. Building a strong and effective social safety net should remain an important element of the program.

We note the financial drains that the major public enterprises are exercising on the budget. Therefore, the reform takes on added urgency, and we welcome the commitment of the authorities to give the needed priority to reforms in this sector. Further emphasis needs to be placed on improving financial management. In this context, the intention of the authorities to impose strict limits on government subsidies and loan guarantees to public enterprises is welcome. If implemented strictly, this measure has the potential to improve significantly the efficiency of this sector. Moreover, we welcome the efforts of the authorities to give greater autonomy to the enterprises and to encourage private ownership of public enterprises.

In conclusion, we commend the Zimbabwean authorities for keeping the adjustment program broadly on track, and for implementing social projects that have helped to maintain social stability, which is so important for the success of the program. We can support the proposed decision, including the request for waivers.

Mr. Al-Tuwaijri made the following statement:

The Zimbabwean authorities have achieved significant progress thus far under the current program. This ambitious program was put in place in the midst of a food emergency, and the authorities' successes have brought the economy closer to achieving a path of economic sustainable growth. As Mr. Dlamini points out in his helpful opening statement, real GDP growth is expected to more than double to 4.4 percent in 1994. Nevertheless, it is regrettable that a number of setbacks have taken place since the previous discussion. Particularly worrisome are the fiscal slippages and the delays in structural reforms that have taken place.

The need to strengthen efforts to reduce the fiscal deficit, which reached 11.2 percent of GDP in 1992/93, as well as advancing structural reforms, cannot be overemphasized. In particular, the delayed implementation of the reforms to public sector enterprises and the civil service retrenchment program needs to be addressed promptly. Any further slippages in these areas would risk creating a backlog of structural reform measures and jeopardizing the medium- and long-term prospects of the economy.

Having said this, the ambitious target to contain the deficit at 5 percent is certainly a step in the right direction. It is important to ensure that this target is met, not only to restore macroeconomic balance, but also to enhance the authorities' credibility. In this respect, the authorities are urged to remain ready to undertake supplementary measures as necessary in the face of adverse unforeseen circumstances, as the economy remains highly vulnerable to exogenous shocks. I would stress that it is equally important that the authorities keep the medium-term fiscal goals clearly in focus as they implement any such supplementary measures.

A meaningful and durable reduction in the fiscal deficit can be achieved only through substantial progress in a number of structural areas. The public sector, as Mr. Dorrington pointed out, continues to crowd out private investment and to dominate too many domestic markets. Like Mr. Dorrington, I see significant scope for increasing private sector participation in the economy, particularly in view of Zimbabwe's fortunate position of having one of the more developed capital markets in the region.

A successful containment of the fiscal deficit, coupled with structural reform measures, would greatly ease the burden on monetary policy. While monetary policy was largely successful in reducing the rate of inflation during the past program year, such success cannot be expected to continue without supporting measures. This is especially the case, as anticipating the demand for financial assets in the coming recovery phase would be complicated by the introduction of foreign currency accounts for individuals and corporations. A successful reduction in the fiscal deficit would also facilitate the maintenance of a tight monetary policy stance, while allowing for increased access to credit by the private sector.

With these remarks, I support the proposed decisions.

Mr. Ishida made the following statement:

At the previous discussion in May 1993, the staff reported that almost half of the performance criteria had not been observed. For the current discussion, it is again apparent that more than half of the performance criteria for end-June 1993 were missed. This gives rise to questions about whether it is possible for the Fund to continue the support for a country, when the performance is half off track. If the authorities made their best efforts to keep the program on track, perhaps the program was not adequately designed.

We have seen a number of countries that were forced to give up their expected disbursements and/or their second- or third-year enhanced structural adjustment arrangements, owing to the nonobservance of several performance criteria. Performance criteria related to net domestic borrowing by central governments and operating losses of major public enterprises are essential; they are often the most important criteria for the success of Fund-supported programs. In the case of Zimbabwe, the deviations were not negligible. The actual figure for government borrowing from the central bank was more than three times greater than the targeted amount, and the operating loss of the public enterprises was almost twice the targeted level. I wonder what standard is used by the staff to determine whether the Fund can continue to support cases involving nonobservance of performance criteria.

Having said that, we do not deny the possibility of extenuating circumstances leading to the authorities' request for waivers of performance criteria, as the remaining adverse effects of the drought of 1992 made it difficult for the authorities to implement a sharp reduction in budgetary expenditures and reform of the public enterprises. In addition, I recognize that, despite the large deficit, which has been financed by borrowing from the central bank, the monetary authorities succeeded in decreasing the rate of inflation gradually through strict monetary policies.

In light of these facts, I support the proposed decision, with the strong hope that there will be no more requests for waivers of performance criteria.

The staff representative from the African Department noted that the distribution of free food in Zimbabwe had been aimed at alleviating the devastating effects of the drought. Indeed, it was a credit to the authorities that no lives had been lost as a result of the drought. During the drought of 1991/92, free food had been distributed to large numbers of people, mostly in rural areas. The distribution of food had been followed by allocations of seed packs to enable the population to start new crops, and producer prices were raised to elicit renewed production. The current excess supply of foodstuffs attested to the overwhelming supply response to those measures.

Zimbabwe was a member of the Preferential Trade Area for Eastern and Southern African States and the Southern African Development Community, the staff representative said. Zimbabwe was also participating in the initiative to facilitate cross-border private investment, trade, and payments in eastern and southern Africa. Zimbabwe would likely benefit from the efforts currently under way to foster regional economic integration. In the context of the current program, the staff hoped to see evidence that those efforts were being translated into concrete policy improvements not only in Zimbabwe, but also in other countries in the region.

The issue of land reform had been discussed extensively at the Consultative Group meeting in December 1993, the staff representative recalled. At that time, the head of the Zimbabwean delegation, the Minister of Lands and Agriculture, and the President of the Commercial Farmers Union had released a joint statement indicating that they were committed to the pursuit of a cooperative approach in formulating and implementing a sustainable resettlement program. The main objective of the resettlement program was to establish viable family-owned and operated farms in each province and to provide the Commercial Farmers Union with adequate representation on the provincial land identification committees, which were to be responsible for identifying land for acquisition. The Consultative Group had expressed support for the proposed land reform efforts aimed at securing a more equitable distribution of agricultural land for small holders in communal areas. At the same time, donors had emphasized the need for prudent implementation of the program in order to promote future investment and agricultural productivity.

Although the exchange rate chart contained in the staff paper indicated that the nominal exchange rate had been maintained more or less unchanged for most of 1993, it should be noted that, owing to insufficient data, the last month of 1993 and the first month of 1994 had not been included in that chart, the staff representative stated. During that period, the exchange rate had depreciated, at first slowly and then by a step of 17 percent. Therefore, the nominal exchange rate had not been maintained through the end of the year. While it would be premature to try to identify an exchange rate target, the authorities had indicated that the exchange rate policy would be guided by the level of reserves and that competitiveness would be maintained primarily through the pursuit of tight financial policies. In that respect, the authorities hoped to maintain exchange rate stability over the period ahead.

While the projections for a reduction of the deficit from 11.2 percent in 1992/93 to 5.8 percent in 1993/94, and to 5 percent by the end of the program period were ambitious, they were realistic, especially given that drought-relief expenditures were to be eliminated in the period immediately ahead, the staff representative commented.

As to the prospects for closing the financing gap of US$120 million in 1995, it should be noted that, as a result of the recent Consultative Group meeting, the financing gap of US$86 million for 1994 had been filled by additional commitments, the staff representative continued. That experience suggested that firm implementation of the program would permit a closing of the gap currently projected for 1995. However, the possibility of a further strengthening of policies should not be excluded.

The National Oil Company of Zimbabwe had been left on the list of enterprises subject to a program ceiling on aggregate losses, despite the fact that it had realized some profits in the recent past, because projections indicated that the enterprise was not likely to continue to make such profits in the future, the staff representative commented. In light of the need to ensure that oil pricing policies were appropriate and that no future losses would be incurred in that area, the authorities agreed that the National Oil Company should remain on the list.

With respect to the indication by the authorities that the exchange rate would be unified as soon as possible, but no later than end-1994, the authorities were aware that an earlier unification might be advantageous for them, the staff representative stated.

A representative from the Monetary and Exchange Affairs Department was currently in Zimbabwe providing technical assistance to the authorities on the revision of the Reserve Bank Act, the staff representative commented. Nevertheless, given the need to draft a new law related to the banking system, the target to have the reform of the banking sector under way by March 1994 might prove to be overly ambitious. However, the new Reserve Bank Act was expected to be in place by the time of the next program review.

In response to the question raised by Mr. Isataev, no country could deal adequately with an unemployment rate of 25-30 percent, the staff representative considered. The outcome of the restructuring of the civil service would likely result in a significant transfer of workers to the informal sector, which, of course, underscored the need to create macroeconomic conditions that would be conducive to a resumption of growth in the private sector.

In response to a question from Mr. Ishida, the staff representative from the Policy Development and Review Department noted that five performance criteria had not been observed in the case of Zimbabwe. In assessing the prospects for future performance, and the grounds for waivers, it was necessary to consider whether the problems that had caused the slippages had reversed themselves or whether policies had been sufficiently strengthened, including through appropriate prior actions. There was frankly also a need to work with a Government that was committed to strengthening its capacity to achieve future targets. In the case of Zimbabwe, the staff considered that sufficient assurances were in place to continue with the program.

Mr. Dlamini made the following concluding remarks:

As the staff has addressed most of the questions raised by Directors, I will comment on only the pace of reform and the authorities' commitment to the program.

As Directors are aware, during periods of crisis, it is difficult to cut back on certain expenditures, especially those that are socially sensitive. Nevertheless, at the peak of the drought, the Zimbabwean authorities eliminated subsidies on maize meal, which is the staple food, and bread, another basic commodity. This is a clear sign of their commitment to the reform program. The authorities would agree with Directors that public enterprise reform and a reduction of the bureaucracy are key elements in fiscal consolidation, and urgent action is needed in those areas.

At the time that the 1992/93 targets on civil service retrenchment and parastatal losses were being set, the authorities had no way to predict weather conditions or the level of labor retrenchment in the private sector. The fact that the authorities had to adjust their schedule was more a matter of facing reality than a retreat from the reform effort.

The privatization of public enterprises remains an integral part of the Government's adjustment strategy, and steps are being taken in this direction. The authorities are also promoting private indigenous economic activity, which should also help to reduce the level of unemployment. This is not being done at the expense of foreign investment, as the measures being taken on taxation, liberalization of investment regulations, dividends remittance, and capital repatriation are meant to attract foreign investors.

Finally, I am grateful to Directors for their helpful comments, which will be conveyed to the authorities. The additional financial support of the Fund and its policy advice will give the Zimbabwean authorities further impetus in their reform efforts.

The Executive Board then took the following decisions:

<u>Enhanced Structural Adjustment Facility - Second Annual Arrangement</u>

1. The Government of Zimbabwe has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised the progress of Zimbabwe in implementing the policies and reaching the objectives of the

program supported by the first annual arrangement, and notes the updated policy framework paper for Zimbabwe set forth in EBD/94/14.

3. The Fund approves the second annual arrangement set forth in EBS/94/5, Supplement 1.

Decision No. 10586-(94/11), adopted
February 14, 1994

Review Under Extended Arrangement

1. Zimbabwe has consulted with the Fund in accordance with paragraphs 2(c) and 4(d) of the extended arrangement for Zimbabwe (EBS/92/141, Sup. 2, 10/21/92) and paragraph 5 of the letter of August 10, 1992 from the Senior Minister of Finance of Zimbabwe, in order to review progress in the implementation of its program supported by the extended arrangement and to establish the phasing of further purchases under that arrangement, as well as the applicable performance criteria and frequency of program reviews during the second year of the extended arrangement.

2. The letter (EBS/94/5) with the annexed memorandum of economic and financial policies dated January 12, 1994 from the Acting Minister of Finance of Zimbabwe shall be attached to the extended arrangement for Zimbabwe, and the letter of August 10, 1992 from the Senior Minister of Finance shall be read as supplemented and modified by the letter and memorandum dated January 12, 1994.

3. Accordingly, paragraphs 2(b) and (c) and paragraphs 4(a), (b), and (c) are amended to read as follows:

"2. (a)...

(b) Until February 13, 1995, purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 86.9 million, provided that purchases shall not exceed the equivalent SDR 67.8 million until June 30, 1994.

(c) The right of Zimbabwe to make purchases during the third year shall be subject to such phasing as shall be determined."

"4. Zimbabwe will not make purchases under this extended arrangement:

(a) throughout the second year, during any period in which the data at the end of the preceding period indicate that

(i) the ceiling on net domestic assets of the Reserve Bank of Zimbabwe, or

(ii) the ceiling on the budget deficit of the Central Government, or

(iii) the ceiling on the combined operating loss of nine major public enterprises, or

(iv) the ceilings on medium- and long-term new commitments of nonconcessional external borrowing by, or guaranteed by, the public sector, or

(v) the ceiling on the stock of short-term external borrowing by, or guaranteed by, the public sector, or

(vi) the floor on net international reserves of the Reserve Bank of Zimbabwe referred to in paragraph 45 and specified in Table 1 of the memorandum annexed to the letter dated January 12, 1994, is not observed; or

(b) if Zimbabwe does not carry out the intentions with respect to the increase in the export retention rate, or the reduction in the civil service establishment, or the maize pricing policy applied by the Grain Marketing Board, referred to in paragraph 46 and specified in Table 2 of the memorandum annexed to the letter dated January 12, 1994, or

(c) during any period after June 29, 1994, until the review contemplated in paragraph 46 of the memorandum annexed to the letter dated January 12, 1994 has been completed."

4. The Fund determines that the review contemplated under paragraphs 2(c) and 4(d) of the extended arrangement for Zimbabwe is completed and that, notwithstanding the nonobservance at end-June 1993 of the performance criteria specified under paragraphs 4(a)(ii), (iii), and (v); 4(b); and 4(e)(i) and (ii) of its extended arrangement, Zimbabwe may proceed to make further purchases under that arrangement.

Decision No. 10587-(94/11), adopted
February 14, 1994

Exchange System

1. The Fund takes this decision relating to Zimbabwe's exchange measures subject to Article VIII, Sections 2(a) and 3.

2. Zimbabwe maintains the restrictive exchange measures described in EBS/94/5, Supplement 1 in accordance with Article XIV, Section 2, except that the multiple currency practices arising from the premium on sales of export retention scheme entitlements in the secondary market, and from the introduction of foreign currency accounts, are subject to approval under Article VIII, Sections 2(a) and 3. The Fund urges Zimbabwe to remove the exchange restrictions maintained under Article XIV. The Fund welcomes Zimbabwe's intention to eliminate the restrictive exchange measures that are subject to Article VIII as soon as possible, but in any case not later than end-December 1994, and grants temporary approval for their retention until September 30, 1994 or the completion of the next Article IV consultation with Zimbabwe, whichever is earlier.

Decision No. 10588-(94/11), adopted
February 14, 1994

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/10 (2/9/94) and EBM/94/11 (2/14/94).

5. GRENADA - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII, SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from January 24, 1994, Grenada has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/94/20, 2/8/94)

Decision No. 10589-(94/11), adopted
February 11, 1994

6. FORMER YUGOSLAV REPUBLIC OF MACEDONIA - PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

1. The Fund has received a request by the Government of the former Yugoslav Republic of Macedonia for a purchase equivalent to SDR 12.4 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. (EBS/94/19, 2/9/94)

Decision No. 10590-(94/11), adopted
February 11, 1994

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 93/107, 93/114, 93/148, and 93/149 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/94/23 (2/9/94) is approved.

APPROVAL: July 21, 1994

LEO VAN HOUTVEN
Secretary