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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/41

10:00 a.m., April 19, 1995

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
P. R. Narvekar, Deputy Managing Director
A. D. Ouattara, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	M. Sirat
	D. Desruelle, Temporary
J. Bergo	
L. E. Berrizbeitia	V. J. Fernández
I. D. Clark	S. O'Connor, Temporary
	J. M. Jones, Temporary
	J. A. K. Munthali, Temporary
	J. Shields
	R. Glennerster, Temporary
K. P. Geethakrishnan	W. Hettiarachchi
J. E. Ismael	L. M. Cheong
D. Kaeser	K. Link
A. Kafka	A. Calderón
	A. L. Coronel, Temporary
W. Kiekens	J. Prader
	J.-C. Obame, Temporary
	D. Saha, Temporary
G. Lanciotti	N. Coumbis
K. Lissakers	B. S. Newman
H. Mesaki	T. Fukuyama
A. Mirakhor	M. J. Mojarrad, Temporary
	S. Rouai, Temporary
C. Saito	
S. Schoenberg	E. Wagenhoefer
A. S. Shaalan	Y. Y. Mohammed
	A. V. Mozhin
	B. M. Lvin, Temporary
E. L. Waterman	J.-H. Kang
J. de Beaufort Wijnholds	O. Havrylyshyn
	Wei B.

L. Van Houtven, Secretary and Counsellor
J. W. Lang, Acting Secretary
C. P. Clarke, Assistant
D. Rajnes, Assistant

Also Present

IBRD: K. T. Yurukoglu, Europe and Central Asia Regional Office. Administration Department: K. B. Dillon, Director; C. Ahl, T. Cole, D. S. Cutler, J.-R. C. Gollé, A. D. Goltz. African Department: E. A. Calamitsis, Director. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; Y. Horiguchi, Deputy Director; M. J. Buchanan, L. E. DeMilner, L. Hansen, P. M. Keller, P. Njoroge, P. M. Keller, L. E. Psalida, T. O. Saavalainen, R. P. van Rooden, B. S. Weder. External Relations Department: S. J. Anjaria, Director; M. R. Kelly, Deputy Director; F. Baker Meio, P. M. Falcone, H. P. Puentes. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; O. T. Kanaan, A. Schipke. IMF Institute: P. B. de Fontenay, Director. Legal Department: R. H. Munzberg, Deputy General Counsel; P. DeBoeck, J. L. Hagan, Jr. Monetary and Exchange Affairs Department: W. E. Alexander. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; B. J. Aitken, L. D. Everaert, N. L. Happe, T. Leddy, S. M. Schadler, J. K. Wakeman-Linn. Secretary's Department: A. Mountford, W. S. Tseng. Statistics Department: J. B. McLenaghan, Director. Treasurer's Department: D. Gupta, Deputy Treasurer; J. Berrigan, L. U. Ecevit, K. M. Kenney, B. E. Keuppens. Office of the Managing Director: G. R. Saunders, Personal Assistant; P. I. Koupaki, J. Prust; Office of Internal Audit and Review: M. Caiola, Director; Office of Budget and Planning: L. A. Wolfe, Director; J. G. Blanch; C. W. Diener, P. J. McClellan, P. J. McPhillips, M. Oka, H. Wiesner, A. A. Zimmerman. Advisors to Executive Directors: J. O. Aderibigbe, A. Chang Fong, S. S. Farid, S. K. Fayyad, J. Guzmán-Calafell, He J., A. R. Ismael, J. Justiniano, R. Kannan, M. F. Melhem, G. Mucibabici, T. Oya, M. Petrie, C. F. Pillath. Assistants to Executive Directors: S. Arifin, P. I. Botoucharov, D. Daco, J. Dagusun, M. Dzervite, G. El-Masry, J. C. Estrella, A. Galicia, M. Giulimondi, A. Guennewich, J. Hamilius, O. Himani, C. Imashev, S. Ishida, P. Jilek, T. Kanada, W. C. Keller, A. M. Koulizade, E. Kouprianova, V. Kural, G. A. Kyriacou, N. Laframboise, K. J. Langdon, Ng C. S., J. Pesola, N. Prasad, M. W. Ryan, K. Sakr, A. Sighvatsson, T. Sitorus, V. Trivedi, V. Verjbitski, R. von Kleist, Wang Y., J. B. Wire, E. L. Zamalloa.

1. AZERBAIJAN REPUBLIC - PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on the Azerbaijan Republic's request for an initial purchase under the systemic transformation facility in an amount equivalent to SDR 29.25 million (EBS/95/59, Sup. 1, 4/5/95; and Sup. 2, 4/18/95). They also had before them the authorities' letter of intent (EBS/95/59, 3/30/95).

The staff representative from the European II Department said that the financial targets for March would likely be observed by a wide margin, owing to an increase in the collection of tax arrears. Furthermore, no credit had been issued to the Government during the first quarter of 1995; more foreign exchange had been accumulated than anticipated; and monthly inflation in March had fallen to below 3 percent.

Mr. Kaeser made the following statement:

> The request presented by the Azerbaijan Republic is obviously the last one that can benefit from the terms and conditions of a first purchase under the systemic transformation facility (STF). If approved by the Board, this operation would represent the finishing element of the crucial starting support provided by the Fund to this troubled region as well as to most countries of the former Soviet Union. My Azerbaijan authorities are grateful to the Executive Board for having extended this facility in order to give them the possibility of benefiting from it.
>
> They also wish to express their thanks to the staff and to the resident representative for the invaluable assistance provided to their country in the elaboration of their program for an orderly transition toward the market economy. The number of missions necessary to draft and finalize this program shows that the staff had not only to negotiate with but also to convince their Azerbaijan counterparts. My authorities highly appreciate the staff's patience and dedication in this respect. They also thank the Fund for the technical assistance provided to their country in order to build up the institutional infrastructure necessary for program implementation.
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> As my Azerbaijan authorities are in full agreement with the staff paper, I can be brief. The program presents the usual patterns for a first purchase under the STF. Its major objectives are to reduce the monthly inflation from an average of 29 percent in 1994 to about 5 percent by mid-1995 and to about 2 percent by the end of the program, to restore a sound balance of payments and external reserve position of the central bank, and to halt the decline in output and real income in 1995. All prior actions have been implemented, namely, the unification of the exchange rate, the abolition of the hard currency budget, the transfer to the

central bank of all official foreign currency holdings, the cancellation of the automatic overdraft facility granted to the two major state banks, the increase of the refinancing rate of the central bank to 17.5 percent, the abolition of the state order system, and the elimination of the bread price subsidy. In addition, the payment arrears to Turkmenistan have been rescheduled, the prices of crude oil and oil products have been raised to 66 and 75 percent respectively of the world market levels, and the price of gas has been brought in line with the cost of importation. With these prior actions, the implementation of the program is already well under way.

The program sets the usual macroeconomic benchmarks, notably with a limit of 2 percent of GDP for the domestic financing of the state budget. The main challenge facing the authorities is bringing down the overall budget deficit from 13 percent of GDP in 1994 to about 5 percent in 1995, the more so as this massive curtailment comes with a major structural transformation on the expenditure and the revenue sides. On the revenue side, the authorities have to compensate for the shortfall caused by the elimination of the surrender requirement, which provided half of the budget revenue in 1994. They introduced, therefore, various measures to widen the tax base and to improve tax collection, notably from the emerging private sector. The value-added tax was extended to foodstuffs and other essential goods as well as imported goods. A temporary tax on exports of strategic goods--oil products and cotton--will be rescinded when the difference between domestic and international prices disappears.

The challenge facing the authorities looks somewhat more manageable if one takes into account that the lasting cease fire in the Nagorno (Daghlig) Karabakh conflict allows sizable cuts in defense outlays and that the elimination of the bread price subsidy permits savings in the range of 8 1/2 percent of GDP. At the same time, the expenditures on the social safety net should increase by only 2 percent of GDP. The development of a program for improving the efficiency of the social safety net is a structural benchmark for end-June. In order to facilitate the management of the budget, a Treasury will be established by end-1995.

In the field of structural benchmarks, Azerbaijan does not lag behind what it contained in other STF programs. In particular, the Azerbaijan authorities are committed to speeding up the privatization process on the basis of a program to be reviewed by the World Bank. The State Property Committee has been strengthened, and a new Deputy Prime Minister responsible for the implementation of the program has been appointed. The authorities are also ready to impose stricter financial discipline on enterprises and to address the problem of enterprise arrears.

As to the circumstances under which the program has to be implemented, on the one hand, the cease-fire in the Nagorno (Daghlig) Karabakh conflict now has lasted for more than one year and allows the authorities to concentrate their attention on the economic issues. Another important development has been the signing of an agreement with an international oil consortium for the development of the Caspian oil fields. The ratification bonus allows the Azerbaijan authorities to add $70 million to the international reserves of the central bank, while the counterpart in domestic currency covers a large part of the 1995 budget deficit.

On the other hand, about 20 percent of Azerbaijan's territory is under foreign occupation, and the authorities of this country of 7 million people have to care for 1 million refugees. The disruption of transport routes following the Chechnya uprising has contributed to a sharp decline in trade volume. Moreover, the pace of implementation by the international oil consortium of the Caspian project may suffer delays if the negotiations over the routing of the pipeline permitting oil exports to western markets are themselves delayed. Finally, Azerbaijan is a very poor country. According to the World Bank, its 1993 per capita GNP was $730, below the 1993 IDA operational cut-off level of $835; with the output collapse continuing in 1994, it is estimated that Azerbaijan's per capita GNP dropped even further by the end of 1994. Owing to these circumstances, the internal and external situation of Azerbaijan will remain very tense during the remainder of the century. As Azerbaijan has been declared IDA-eligible, the Azerbaijan authorities hope that the Executive Board can give positive consideration to its inclusion, at least temporarily, on the list of countries eligible for the enhanced structural adjustment facility (ESAF). This would substantially alleviate the transition of Azerbaijan toward the market economy.

Mr. Kiekens made the following statement:

I welcome and strongly support the systemic transformation facility for Azerbaijan.

This program marks the nearly full completion of the task that the Fund assumed when this Board decided about two years ago to support the transition countries with a systemic transformation facility. The objective was to prepare these countries as quickly as possible for standard Fund arrangements by helping them to develop the basic institutions and policy instruments needed to manage a market economy and to launch the processes of stabilization and reform. The Fund's success in this momentous task has been made possible by the professionalism, patience, and dedication of the staff. I would like to express, on this occasion, my wholehearted gratitude to each staff member who has contributed to this very considerable accomplishment.

That Azerbaijan is one of the last of the transition countries to initiate the process of economic stabilization, and reform is explained by the numerous adversities that have plagued that country and its neighbors during recent years: internal political instability, the conflict over Nagorno Karabakh, and the disruption of Azerbaijan's transport routes through Georgia and Chechnya and, more recently, all parts of the Russian Federation. For Azerbaijan and other countries of the region, these problems have blocked progress with stabilization, institution building, and structural reform that are the mutually reinforcing parts of a successful transition to a market economy. Quick settlement of political conflicts is the vital first step in setting the stage for the process that will bring well-being to the population.

The program proposed today by Azerbaijan is comprehensive and ambitious, and the authorities have proved their determination by implementing a large number of politically difficult prior actions. The major part of their task still lies ahead, however, and nothing less than steady and thorough implementation of the program will suffice to accomplish it.

The main challenge is that of fiscal adjustment. The overall deficit is targeted to decline in 1995 from 13 percent of GDP to about 5 percent. At the same time, the structure of revenues and expenditures is to be fundamentally changed and substantially reduced in terms of GDP. The fiscal effort will certainly be facilitated by a substantial reduction in military expenditures and by imposition of higher taxes and royalties on oil production, in order to capture for the budget the windfall profits that will result from the sharp increase in domestic oil prices. The Government will also temporarily tax oil and cotton exports to bridge for the duration the differential between domestic and international prices.

These considerations do not prevent me from agreeing with the staff that the fiscal adjustment program is "exceptionally strong." I welcome the initiatives for widening the tax base--particularly that of the value-added tax--to eliminate discretionary tax exemptions and to improve tax collection. This is the more commendable as the authorities intend at the same time to considerably upgrade the social safety net through better targeting and additional funding equal to 2 percent of GDP. Azerbaijan benefits from extensive technical assistance for the establishment of a Treasury and the improvement of its tax administration. I urge the authorities to make substantial progress in these areas.

Although the profound restructuring of expenditures and revenues will be the result of major structural reforms, the reduction of the deficit itself represents an essential precondition for defeating inflation by eliminating the need for monetary financing of the public debt. Tight monetary and financial policies are inseparable allies in this struggle. In the monetary sphere, the program contains the usual performance criteria and benchmarks. Several institutional changes are under preparation, most notably a new central bank law, which will permit the National Bank of Azerbaijan to conduct an independent monetary policy primarily aimed at price stability.

I agree with the Government that in view of the present early stage of the stabilization process and the low levels of Azerbaijan's international reserves, it would not be appropriate to use the exchange rate as a nominal anchor. For this reason the central bank should refrain from intervening in the exchange markets, except for the auctions of foreign reserves scheduled in its financial program. The authorities intend to reconsider their position on the exchange rate regime at the time of their request for a stand-by arrangement. I hope that by then this Board will have completed its reflections--as suggested by Mr. Kaeser--on the merits and drawbacks of the different exchange rate regimes in order to allow our member countries to make more informed decisions after due consideration of all relevant factors, including the structure of their foreign trade.

The authorities have made commendable efforts to prepare a comprehensive privatization program, and to strengthen the State Property Committee. Nonetheless, privatization is still lagging, partly because property rights are not yet clearly defined. I urge the authorities to proceed quickly, with the assistance of the World Bank, with the implementation of their privatization program.

Mr. Newman made the following statement:

Azerbaijan's economic performance over the past few years has been poor, and its overall commitment to reform has been quite weak. As with the other late reformers, the delay in launching a comprehensive reform effort has been costly and--as the recent discussion on the Baltic countries, Russian Federation, and other countries of the former Soviet Union highlighted (EBM/95/26, 3/20/95)--has done nothing to diminish the substantial decline in output. Late though it is, we welcome this STF program and the striking turnaround in the reform process that seems to have taken place over the past few months. I am also pleased to see some encouraging results from the staff resources and technical assistance that have been devoted to Azerbaijan. As we will be discussing the STF decision later today, I would simply note that our willingness to extend the STF permitted Azerbaijan to enter into this kind of program at this time, and we should consider how we might handle other late reformers in the region that have not yet been able to take advantage of the STF.

The substantial prior actions taken since the beginning of the year have gotten the reform process moving in the right direction again. These prior actions are important first steps toward the Government's goal of keeping domestic financing of the budget to 2 percent of GDP, and keeping a tight rein on credit policy in order to achieve the ambitious 2 percent monthly inflation target by the end of the year. The difficult part, however, will be to sustain implementation of the program to bring down inflation, create a hospitable climate for foreign investment, and overcome the legacy of previous failed attempts at reform.

In view of the ambitious inflation targets, the Government needs to make a particularly strong and sustained effort to keep spending under control and improve revenue collection by dealing stringently with exemptions and corruption, and eliminating other administrative weaknesses. As you know, this chair has generally not been in favor of export taxes, even on a temporary basis. I would agree, however, with the staff that export taxes are better than the confiscatory foreign exchange regime that they replaced. Nevertheless, I would like some assurances that these taxes will indeed be temporary, and I would like to know when the price differential will be eliminated so that better solutions can be implemented. On the expenditure side, we particularly welcome the abandonment of the separate foreign currency budget, the removal of key subsidies, retargeting of social safety net expenditures, and the planned reduction in military and security-related expenditures. The willingness of the authorities to actually resort to sequestration as a possible contingency measure will be important in demonstrating whether the reform process can withstand political pressures.

I am generally satisfied with the monetary program and the institutional changes that are under way to improve monetary control and increase the role of market forces. However, I would appreciate additional information on the bifurcated credit auction system that has been set up. Specifically, I would like the staff to comment on the rationale for excluding the two largest banks from the newly established credit auctions, how the central bank will administer the separate refinance credit limits that will apply to these two banks, and how the staff proposes to eventually include the two banks in the auction system so that it is the sole mechanism for credit allocation. Also, I would like to know how the staff intends to ensure that the oil companies do not abuse the new foreign exchange system through sending capital abroad while obtaining financing by borrowing under preferred credit arrangements.

The weakest aspect of the reform process in Azerbaijan has been the absence of substantial progress on privatization; this program has the potential for getting the process restarted. The biggest challenge the Government faces this year is reducing its support for state industries and implementing structural reforms to prevent insolvent firms from bringing down potentially healthy enterprises or the budget. The Government urgently needs to begin actual privatization of viable enterprise and liquidation of nonviable ones. Triage is urgently needed. In this connection, we welcome the planned isolation program that will be put together with the World Bank, which is similar to a program that I understand is now having beneficial effects in the Kyrgyz Republic. The presumption should be that enterprises are not going to come out of this emergency room unless radical surgery somehow makes them viable candidates for privatization.

For potentially viable enterprises, we welcome indications that a privatization program is being developed with guidance from the World Bank, but, as the staff notes, the Government's preliminary plans raise a number of concerns. In particular, we share the staff's concerns that the proposed program does not rely more heavily on cash privatization, and we would like to see firm benchmarks by which to measure progress.

I am also concerned by the Government's plans to deal with interenterprise arrears, in view of the potential adverse impact a poorly designed scheme can have on a Fund program--as in the case of Kazakhstan. I would appreciate the staff's comments on how this operation might be designed so as not to upset fiscal and monetary targets under the program.

As the privatization and enterprise restructuring process moves forward, it will be equally important to address the related problems in the banking sector that are identified in the paper. In this regard, I would welcome the staff's views on the possibility of a complementary World Bank-supported financial sector reform program and the prospects that such a program could be put in place relatively quickly once the privatization effort takes root.

In conclusion, the scenarios prepared by the staff show that the outlook for Azerbaijan over the medium to long term is potentially very good. However, if foreign investment is to be mobilized on the scale contemplated in the program, which--along with progress on stabilization--is the crux of the whole scenario, it will be critically important for the Government to maintain a stable economic environment and make steady progress toward a market economy. Full implementation of this program will send an important signal to the international financial and business community that the authorities have decisively relaunched the reform process.

I have directed a whole range of questions to the staff. I have one question, however, for Mr. Kaeser. In recent Board discussions of programs, he has frequently asked Directors to comment on the willingness of their authorities to ensure that the Fund retain preferred creditor status. I was wondering whether he is willing to give similar assurances in this case.

Mr. Shaalan made the following statement:

I welcome the request by the Azerbaijan authorities for a first purchase under the systemic transformation facility, in support of what is clearly an ambitious--and possibly over-ambitious--macroeconomic stabilization and structural reform program. Azerbaijan's economic crisis has deepened in the course of 1994 with real GDP declining steeply once more, inflation again surging ahead, and the balance of payments weakening further. The considerable progress achieved in the resolution of the Nagorno Karabakh conflict and the conclusion of the agreement for the development of offshore oil deposits in the Caspian Sea, have substantially improved the conditions for embarking on a major stabilization effort. The authorities' implementation of all the program's prior actions, which cover a wide range of areas, is indicative of their commitment to embark on this strong reform effort. Indeed, as Mr. Kaeser notes in his statement, "with these prior actions, the implementation of the program is well under way." I should add that although it is well under way, it does require perseverance.

I am in general agreement with the staff appraisal, and will comment, for emphasis, on fiscal policy, the social safety net, and monetary policy.

On fiscal policy, I am concerned that the fiscal consolidation envisaged in the program may be overly ambitious. The overall government deficit is targeted to decline from 13 percent in 1994 to about 5 percent of GDP in 1995, while the domestic financing of the deficit would drop to 2 percent of GDP. The difficulty of the fiscal adjustment effort is further accentuated by its heavy reliance on expenditure cuts in parallel with a major decline in revenue. The latter is mainly a result of the elimination of the foreign exchange surrender requirement-- which was, admittedly, confiscatory--which accounted for almost half of government revenues in 1994. Only one third of this revenue loss will be compensated for by the introduction of the temporary tax on exports of strategic goods. The net effect of all the revenue measures programmed will still be a drop in revenues of about 5 percentage points of GDP.

Therefore, the expenditure cuts, possibly by necessity, appear quite large and will require strict monitoring to ensure that expenditures do not exceed available revenues and established credit limits, and to avoid new budgetary arrears. The authorities' back-up "cash rationing system" to match expenditures with available revenues in times of unexpected financing short-falls, is welcome--in particular, the system's strict prioritization of expenditure categories which would avoid the negative effects of across-the-board cuts while ensuring adherence to the expenditure target.

Despite the uneven, but possibly necessary, nature of the fiscal adjustment, the improvement in the budget's structure on both the revenue and expenditure sides is welcome. The consolidation of the separate foreign exchange budget into the main budget is particularly noteworthy, as is the removal of the taxation of export earnings through the surrender requirements. The expected integration of all other extrabudgetary funds into the 1996 state budget will be another important step in improving the budget structure. The widening of the tax base through a combination of new taxes and the removal of exemptions to existing taxes is also commendable. A more comprehensive tax reform will be needed, however, to substantially strengthen tax revenues, particularly in view of the temporary nature of certain taxes and the sharp decline in revenue that has occurred or is going to occur this year. Continued technical assistance from the Fund in this area will be very important.

Turning to the social safety net, I find the joint heading for fiscal policy and the social safety net in the report particularly apt, in view of the importance of subsidy reduction in the 1995 fiscal adjustment. While noting that expenditures on social safety net transfers are envisaged to increase by 2 percent of GDP to compensate for the removal of the bread price subsidy and other subsidies, I would stress the need to achieve rapid progress in the efficient targeting of these expenditures to the most vulnerable groups of the population. This chair has emphasized, during our previous discussion on Azerbaijan (EBM/94/52, 6/8/94) and on other occasions, the crucial role efficient social safety nets play in sustaining broad public support for strong stabilization programs.

On monetary policy, the authorities will need to adhere strictly to the established credit limits if they are to reach their inflation objective. Policy has been tightened since the beginning of the year, and I am pleased to see that credit to the Government and banks has remained within program limits in January and February. The discontinuation of the two largest state banks' virtually automatic access to central bank refinance credit should go a long way toward establishing the central bank's control over credit policy. The new central bank law and charter to be submitted to Parliament will also add to the effectiveness of monetary policy by, it is to be hoped, ensuring the central bank's independence. I also welcome the authorities' intention to examine the financial position of major enterprises and their commitment to finalize, by mid-May, a plan for interenterprise arrears settlement without involving bank credit or budgetary resources.

The Azerbaijan authorities are embarking on a stabilization effort that is worthy of the Fund's support. I support the proposed decision and wish the authorities success in their endeavors.

Before ending, as the World Bank has declared Azerbaijan IDA-eligible, I strongly support Mr. Kaeser's request that Azerbaijan be considered for inclusion on the list of ESAF- eligible countries.

Mr. Mojarrad made the following statement:

Modest stabilization gained by mid-1994 gave way to slippages, evidenced by inflationary pressures and sharp depreciation of the manat toward the end of the year. Against these adverse developments, the authorities' efforts in introducing a bold and ambitious program supported by the systemic transformation facility should be commended. The staff paper is sufficiently detailed and has anticipated most of the issues we would have liked to raise. I can therefore be brief and limit my remarks to a few critical areas of the program and some associated risks.

The program rightly emphasizes the continuation of stabilization efforts that the authorities have already been implementing since the beginning of the year. Its primary goal is to bring inflation under control and to set the stage for a sustained recovery in output. Reduction of the monthly inflation rate to 2 percent by the end of the year--from 50 percent in the last two months of the past year--is a daunting challenge requiring a major tightening of the fiscal and credit policies, supported by some wide-ranging structural reforms, particularly in public sector and privatization.

Fiscal policy remains the greatest challenge; the targeted reduction of deficit by 8 percent of GDP requires a major effort in revenue generation and containment of expenditures. On the revenue side, several steps including a temporary tax on exports, have been taken to compensate for the adverse effects of the elimination of taxation through surrender requirement. Additional measures, including extension of the value-added tax coverage introduced in the current budget to widen the tax base, are welcome. Efforts should be directed toward simplification of tax procedure and further improvement of tax administration with technical assistance from the Fund.

The fiscal plan represents a major cut in expenditure amounting to more than 8 percent of GDP coming from the elimination of bread subsidies and sharp cuts in defense and security expenditures. Although the sensitivity of both categories is well understood, the adverse impact of the former on the poor is to be eased by an enhanced and better-targeted social safety net. The latter seems to be justified by the considerable progress made toward a resolution of the regional conflict. It is also crucial for the authorities to resist any wage increases beyond the level envisaged under the program. The recently introduced cash rationing system for matching expenditures with available revenues is a step in the right direction. It requires a balanced prioritization of expenditures, ensuring that politically less sensitive items, such as development expenditures, are not overlooked. Finally, public sector retrenchment will remain to be tackled as the overstaffing, evidenced by the low level of unemployment despite considerable decline in output, remains a heavy burden on the budget.

On monetary and credit policy, we would emphasize the importance of persevering with the tight stance recently taken by the authorities. Financial sector reform remains crucial not to mobilize domestic resources but also to help control inflation. The program envisages a new central bank law and charter expected to be submitted to Parliament by mid-1995. This would allow the National Bank to conduct monetary policy independently, consistent with the inflation objective. In the interim, however, continued vigilance would be needed to ensure strict implementation of the envisaged measures. The National Bank should also be ready to use other instruments like reserve requirement and even more direct ones if indirect measures prove to be less effective. We strongly share the staff's view on the need for major enhancement of the National Bank's supervisory capacity for close monitoring of credit policy.

Lower inflation should lead to real appreciation of the manat and restoration of confidence in the national currency. However, manat appreciation could also trigger more imports and undermine the external current account position. We would be interested to know the staff's view on the desired level of parity under which competitiveness is preserved. We would also appreciate it if the staff could elaborate on the future of the exchange rate system if it is viewed to be different from the existing one.

On the structural side, the overall heavy agenda for economic reform requires firm commitment on the part of the authorities for uninterrupted implementation of the reforms. The steps taken in the areas of price, trade, and exchange rate liberalization are bold, but the remaining measures on adjusting energy prices and breaking up state monopolies call for continued perseverance. Of equal importance is the privatization process that is expected to gather momentum under the program. We encourage the authorities to introduce as a first step the necessary legal framework--corporation law and law defining property rights in agriculture--designed for the safe and sound operation of the private sector. Exploring the privatization modalities would be the next step. The staff refers to the possible suitability of an "isolation exercise" under which certain loss-making enterprises are cut off from financial assistance and studied by the World Bank--a process that may become costly and time consuming. Tough budget constraints could more efficiently determine the need for the permanent closing, downsizing, or restructuring of these enterprises.

To minimize the social costs of the adjustments, a targeted safety net should be designed to protect the vulnerable groups. Because we found little information in the paper on this issue, further comments by the staff would be appreciated.

With these remarks we support the proposed decision and the inclusion of Azerbaijan on the list of ESAF-eligible countries.

Mr. Lvin made the following statement:

It is our pleasure to learn about the extremely bold stabilization program initiated by the Azerbaijan authorities and outlined in their letter of intent. During the previous discussion on Azerbaijan, Executive Directors strongly urged the authorities to break with the then prevailing practices of passive accommodation of fiscal imbalances by the Azerbaijan National Bank, and with pervasive use of highly ineffective forms of state planning and controls.

Clearly, marked improvements in the security situation in the region have played a vital role in the authorities' decision to start reforms. No doubt a dramatically low level of gross foreign reserves, which at year-end stood at the level of $3 million, soaring inflation, and the realization that the bonus payment is not likely to be repeated on a regular basis, were major factors, too. And, last but not least, the staff should be credited for convincing the authorities to believe in the monetary nature of inflation.

Economic conditions in Azerbaijan had become so dire that a dramatic overhaul of the previously employed mechanisms and conceptions was probably the only realistic option. Such an approach seems to be even more warranted, taking into account the poor track record when the most obvious reforms were postponed many times. For instance, it was first announced that the archaic mechanism of the so-called MFO--or interbranch circulation--which represented essentially free banking without clearing constraints, would be terminated as of April 1, 1994; later, it was decided to keep this mechanism in effect until June 1, 1994, even though it was our understanding at the time of the last June Article IV discussion that the MFO had already ceased to exist. According to the staff paper, this system was discontinued only later in 1994.

This time the authorities cannot allow themselves to miss a window of opportunity. Fulfillment of program targets, which the staff correctly defines as ambitious but achievable will require all the authorities' efforts, for uncertainties for 1995 are still extremely high.

We share both the cautious optimism expressed by the staff, and its concerns, and fully support the proposed decision. Therefore, we would like to make only a few comments on the authorities' program.

Because the budget composition and fiscal policy are expected to be almost fully restructured in 1995, and short-term outcomes of such an exercise are, certainly, not easy to predict, the main responsibility will likely rest upon monetary policy. As we understand it, the authorities are preparing to adhere, at least implicitly, to the stable nominal exchange rate target as a means of arresting inflation. Their vigilant approach toward adoption of such a very important decision is fully understandable. Nonetheless, references in the staff paper to the policy failures associated, in the authorities' view, with "the previous experiences with fixed exchange rates" look somewhat irrelevant. To our knowledge, there was no experience with a fixed exchange regime in Azerbaijan, unless we recognize some meaningless claims of the manat being at par with the ruble, or drastic surrender requirement rules, as a true fixing.

We have no intention of making any judgments, but it is interesting to mention that economic settings in Azerbaijan look, to a limited extent, similar to those in Estonia in 1992: external debt, after a rescheduling agreement with Turkmenistan, appears manageable; the real exchange rate is extremely undervalued; prospects of remonetization of the economy are very high; and, finally, there is a substantial one-time inflow of foreign exchange, which roughly covers almost all existing stock of reserve money. The well-known--and recently praised by this Board--decision by Estonia to adopt, under these circumstances, the simplest possible rules of monetary policy has proved very helpful. Features of this choice such as transparency and predictability can have importance in Azerbaijan even more than in institutionally more developed Estonia. Otherwise, the authorities might be forced to further rely on flawed perceptions and unreliable statistics in making some important decisions, such as what interest rate should be used by the Savings Bank; what centralized credit limit should be established for the two largest state banks; and how to divide this quota between them.

The list of prior actions is very impressive, and we commend the authorities for their full implementation. In view of a substantial backlog of various structural reforms in Azerbaijan, the present momentum should be maintained, and measures designated as structural benchmarks should be given unconditional priority by the authorities. For example, deregulation of foreign trade must be completed as specified. Our own experience demonstrates how powerful vested interests are in foreign trade, and how difficult it is to correct wrong decisions in this area. Thus, we urge the authorities not to allow any complacency here.

Another area that requires substantial speeding up is undoubtedly privatization. According to the staff paper, the previous privatization program, assessed as "modest," has been terminated in anticipation of the new comprehensive one. We are not sure that this is the right decision. The best way for the authorities to earn badly needed credibility is to implement all reform measures adopted, even modest ones. We hope that the new privatization program, which is to be presented soon, will feature some bold measures with respect to land distribution, because labor-intensive agriculture could alleviate the social burden of the budget, generate meaningful export incomes, and even provide temporary employment for displaced persons. As to privatization of industrial enterprises, it is important to prevent any bailout of arrears in the course of pre-privatization restructuring.

Finally, we fully support the idea of resolving the issue of ESAF eligibility for Azerbaijan. Provided present strong reform measures are being implemented, the three-year framework of the ESAF-supported program would markedly increase the authorities' credibility.

Mr. Havrylyshyn made the following statement:

As I agree with the thrust of the staff paper and most of the constructive remarks of other Directors, I can be brief.

The Azerbaijan program we have before us today is yet another example demonstrating that STF programs can and do entail a strong degree of conditionality. The prior actions alone are already very substantial steps forward, although their eventual effect depends on thorough implementation of the program's measures in the fiscal, monetary, foreign trade, and structural areas. Although the program targets are very ambitious. the important question is whether they can be less ambitious than this. Having had the pleasure in the past of speaking on behalf of other, similar programs that some regarded as too ambitious, I feel comfortable today saying: yes, it is ambitious; but no, it cannot be less ambitious.

The staff and Mr. Kaeser have described the basic elements of the program and their rationale. Let me say only a few words about the risks, focusing on two areas: fiscal and external.

Fiscal targets face the obvious risk of political will for implementation, but equally important are risks of administrative delays. As an example, a great deal of effort needs to be addressed to restructuring quickly the social safety net from the old form--general subsidies on key goods--to the new form--needs targeting. The intentions in the program are the right ones, but as earlier efforts in some of my own constituents and others show, it is not a simple matter to implement all the legal, administrative, and technical changes to achieve a targeted social safety net. If these changes are long delayed, the political pressures to retain or return to general subsidies build up very quickly.

In the event of slippages, would the Azerbaijan authorities plan such contingency measures as sequestering? Although it is preferable to achieve fiscal consolidation through the measures proposed, the blunt axe of sequestering can still be a very necessary second- or even third-best measure so early on in stabilization--a lesson many of us from transition economies have learned the hard way.

Another important risk lies in the external balances; should these turn out to be worse than the projections in the program, renewed pressures will arise for administrative measures of foreign exchange allocation. Only a firm hand in maintaining the liberalization achieved by the prior actions can offset these pressures. Here, I join Mr. Lvin in emphasizing the importance of bearing in mind the strength of vested interests and, therefore, the need to be very firm in pushing through these measures. As regards the program's financing and external gap, I expect Azerbaijan will find its fourth quarter financing gap will be successfully filled at the consultative group meeting in Paris at end-May 1995. If this were not to be the case, the risks in this area would be proportionately greater than the small financing gap amount.

I add my support to consideration of Azerbaijan as ESAF-eligible. Like Mr. Newman, I would appreciate it if Mr. Kaeser would comment on his authorities' commitment to the Fund's preferred creditor status.

Let me conclude by saying I strongly support the proposed decision and welcome the efforts of the Azerbaijan authorities.

Mrs. Wagenhoefer made the following statement:

As we are all aware, the conflict over Nagorno Karabakh has had a very negative impact on the Azerbaijan economy. Azerbaijan was also confronted with the disruption of trade and payments between the republics of the former Soviet Union, including disruptions of land transportation routes. However, the existing macroeconomic imbalances cannot be traced only to external factors. Policy slippages and a lack of market-oriented structural reforms also contributed to the deterioration of the economic situation. Fortunately, prospects have meanwhile brightened considerably. There has been progress toward peaceful settlement of the conflict, and Azerbaijan has signed an important agreement with an international oil consortium. These developments, together with the measures agreed under the proposed STF arrangement, are important steps toward realizing Azerbaijan's considerable economic potential.

The program itself appears broadly appropriate. The strategy rightly focuses on quick stabilization and on an acceleration of the process of structural transformation. The key question will be its implementation. With the large number of strong prior actions already implemented, the authorities have shown their commitment to the adjustment policies. We hope that the authorities continue the commendable current reform momentum over the whole period of the program.

On monetary policy, we welcome the fact that the major obstacle for monetary policy, the automatic access of state banks to central bank refinance, was removed in October last year. The tightening of monetary policy in January this year has led to impressive results--a halving of the inflation rate in January and again in February, and positive real interest rates. The adoption of the new central bank law, allowing the central bank independent monetary policy with the overriding objective of price stability, will be a further important step toward ensuring low inflation.

Turning to fiscal policy, the planned reduction of the overall deficit from 13 percent to 5 percent for 1995 at first signals a very strong target; however, I wonder whether this decline is not largely due to a reduction in military expenditures. Welcome as the reduction in military outlays is, the deficit reduction would thus be the consequence of the improved political situation rather than of genuine fiscal consolidation. It would be interesting to know to what extent the substantial reduction of the deficit can be traced to this particular effect and how much to genuine adjustment efforts.

With respect to structural reforms, price and trade liberalization are key elements of the transition to a market economy, and in this area, the authorities have made commendable efforts. We hope that the authorities will be able to fulfill their intention to largely complete the process of price liberalization during the program period, in particular with regard to the energy prices. Another cornerstone of structural reforms is the development of the private sector, but in this regard, we regret that the privatization process has been slow thus far. Furthermore, we share the staff's concern about the authorities' preference for using a voucher system in the privatization of medium- and large-scale enterprises. We hope that the blueprint for a comprehensive privatization program will speedily be turned into reality.

Turning to external sector policies, we would not go so far as the staff did, assessing the short-term outlook as "precarious." The expected deterioration in the trade balance is mainly the other side of the coin of capital inflows from the oil consortium. As the current account deficit is largely investment driven, we are inclined to welcome the projected development. We would be pleased if there were similarly comfortable private capital inflows into other countries in transition. The current account deficit will probably be reversed through oil exports beginning in 2001. The main risk Azerbaijan might face is unexpected political interference with the oil field development.

Mr. Desruelle made the following statement:

I welcome today's discussion of Azerbaijan's request for a first purchase under the systemic transformation facility. The situation in Azerbaijan has been difficult politically as well as economically. It is therefore heartening to see that the Azerbaijan authorities are now ready to embark on a comprehensive program of stabilization and reform.

In view of the initial conditions, it is clear that the task of stabilizing the economy will not be easy, and that determined actions by the authorities will be needed to keep the program on track. But, like many previous speakers, I am very much encouraged by the full implementation of many prior actions.

I agree with the architecture of the program, including its emphasis on strict financial policies and its attention to strengthening financial discipline of enterprises. I therefore will content myself with some specific remarks on the program.

Like previous speakers, I find the program's targets ambitious.

On fiscal policy, I have no difficulty with the taxation structure adopted in 1995 in response to the loss of revenue from foreign exchange operations. For 1996 and beyond, however, there is a need for further reforms and, in particular, a need to establish the appropriate regime of energy taxation from a medium-term perspective. In view of the importance of the oil sector in Azerbaijan, this sector should be a major source of fiscal revenue.

On monetary policy, I welcome the care put into the design of the central bank's credit auctions in light of potential problems of collusion and adverse selection. Even with these precautions, however, it will be important to remain vigilant to potential difficulties in attaining a "true" market price for money in the auctions. In this respect, I would welcome the staff's assessment on the present ability of the Azerbaijan National Bank to adequately monitor the financial position of participant banks.

On arrears, enterprise discipline, and enterprise restructuring, the authorities must be commended for their efforts to set the right example by eliminating budgetary arrears. I welcome as well the stress put on tackling interenterprise arrears, as in other countries in transition many enterprises attempt to deal with a tightening of credit conditions by running arrears. I look forward to the full elaboration of the plan to address interenterprise arrears by end-May 1995.

On enterprise restructuring, I see much merit in the staff's suggestion to implement, with the help of the World Bank, an "isolation exercise." At this stage, I would welcome clarification on paragraph 42 of the letter of intent, and in particular what precise conditions would be put on so-called "transitional financial support while restructuring plans are being prepared and implemented."

On exchange rate policy, I welcome the authorities' intention to continue to rely at this stage on a flexible exchange rate regime. In light of the large prevailing uncertainties in macroeconomic developments, and in the response of economic agents to the process of stabilization, this is the appropriate course at this time. In this respect and in relation to the ambition of the macroeconomic targets mentioned earlier, I have some doubts as to the feasibility of stabilizing the nominal exchange rate as rapidly as indicated in Chart 2, even though I am aware of the elements pointing to an undervaluation of the real exchange rate. External policies, in conjunction with financial policies, must be geared to a sustainable stabilization of the exchange rate. To that end, a favorable evolution of external reserves through careful management will be as important as the actual rate of change of the value of the currency.

Finally, on Azerbaijan's ESAF eligibility, this chair is prepared to consider the issue in the framework of our usual rules on this matter.

Mr. Kiekens, noting that a vital element for Azerbaijan and other countries in the region was a satisfactory solution to the problem of transportation of oil and gas, wondered what the prospects for Azerbaijan were in that area. He favored including Azerbaijan on the list of ESAF-eligible countries, adding that the country's potential could mean a quick graduation from ESAF status.

The staff representative from the European II Department mentioned that a number of plans were being considered to improve oil transport, such as pipelines through Georgia, through Chechnya into Russia, and through Iran into Turkey. The authorities did not need to make a final decision for three or four years. The first step of the new oil field rehabilitation and development project would be to halt the decline in output, which had been falling for years, increase output mainly from existing fields over the following three or four years, and bring new oil fields on stream thereafter. The country had a large refining capacity--twice domestic demand. Developments in the oil sector, and particularly the opening of the export pipeline, would have a significant impact on the balance of payments and the budget.

The authorities had agreed to raise energy prices to world levels by mid-1995, when energy export taxes would also be abolished, the staff representative stated. The chief export tax revenue source was cotton; the authorities intended to abolish that tax toward the end of 1995, following the fall cotton harvest.

Mr. Newman, noting the intention to abolish the cotton export tax, asked the staff how the authorities intended to replace revenue from that source.

The staff representative from the European II Department replied that the removal of export taxes would leave cotton producers and SOCAR, the state oil company, in a more profitable position, and to that extent, increased profit taxes would offset some of the lost revenue. However, it was also clear that additional measures needed to be taken, perhaps in the context of a second systemic transformation facility purchase, in conjunction with either a stand-by or ESAF arrangement.

Official exchange holdings in the National Bank had been only $3 million at the time of the staff's discussions with the authorities in September 1994, the staff representative noted. At the time, the uncertainty surrounding the foreign exchange position and the budget had led the authorities and the staff to rule out setting up a currency board. Large foreign exchange inflows, linked to the development of the oil sector, could lead quickly to a large monetary expansion in the future. That would need to be offset by an appreciation of the exchange rate; even at present, foreign exchange inflows should serve to bring about a nominal appreciation of the exchange rate. A currency board arrangement remained an option for the future, however.

The reduction in inflation had been quite dramatic, no doubt helped by the relative exchange rate stability since the beginning of the year, the staff representative considered. Much lower wages in Azerbaijan than elsewhere in the region--e.g., in the Kyrgyz Republic--suggested that substantial room existed for a large real appreciation in the exchange rate. Such a real appreciation might be brought about more quickly, given the already tighter monetary policy, through a nominal appreciation.

The authorities had committed themselves to a tight credit policy, including high interest rates, and they were enforcing the payment of taxes by the state oil companies, the staff representative explained. That, rather than capital controls, would ensure that a fair amount of oil money would flow into the banking system. In addition, SOCAR held--for legitimate reasons--substantial amounts of foreign exchange, currently estimated at $35 million.

Bifurcated credit auctions had just begun, the staff representative noted. The staff had realized that the two largest state banks could collude with one another and dominate the formation of interest rates, so they had been excluded from participating in the auctions. Because the National Bank was concerned about the soundness of the balance sheets of participating banks in the auction, the first auction had been small, with only nine banks participating. The National Bank's ability to evaluate the balance sheets of candidate participants would take additional time and study. Since many of those banks were saddled with bad assets of state enterprises, assessing the balance sheets would prove difficult, especially in a high-inflation environment. As in other countries, weaknesses in the banking system would become apparent as credit policies were tightened.

The World Bank was eager to proceed quickly with the financial sector reform program, the staff representative observed. The staff had agreed with the authorities to station a central bank advisor in Azerbaijan to provide technical advice on financial sector reform.

Mr. Newman wondered how access to central bank financing for the two largest banks would be controlled, given their exclusion from the credit auction.

The staff representative from the European II Department responded that the overall volume of refinanced credit was determined on a weekly basis, with a certain amount set aside by the National Bank to be allocated to those banks at the auction-determined interest rate. Thus, the overall credit volume was partially channeled through the auction, and partially allocated through the state banks. However, the staff felt that that was not an ideal system in the long run.

While the budgetary impact of privatization and the related isolation exercise was difficult to forecast, the experience of the Kyrgyz Republic suggested that that impact would be limited, the staff representative considered. The initial step of cutting off selected enterprises from access to bank credit had the effect of strengthening the banking system. The real budget costs would come with restructuring, at which time separation payments would have to be made to laid-off workers and interenterprise debts settled.

The clearance of arrears needed to be addressed along the lines of the Enterprise Reform and Resolution Agency (ERRA) that had been set up in the Kyrgyz Republic, the staff representative said. Having studied other countries of the former Soviet Union, the authorities were aware of the risks accompanying interenterprise arrears. The authorities intended to cancel the offsetting obligations between enterprises--a time-consuming process. Complicating the interenterprise arrears problem were the foreign exchange accounts under enterprise control. Prior to the economic transition period, only domestic currency-denominated accounts belonging to enterprises were debited when payment became due, leaving their foreign exchange accounts untouched; that situation persisted. One approach under consideration would be to also charge foreign exchange accounts when bills became due--a move that would help to reduce the interenterprise arrears problem.

The staff understood that the World Bank was actively engaged in a policy dialogue with the authorities on a privatization program, the staff representative noted.

The social safety net package had not yet been developed, even though the technical assistance mission from the Fiscal Affairs Department had made a number of specific recommendations in that area, the staff representative explained. The staff planned to send a team in May to Baku to discuss the options available, such as better targeting of the safety net. For example, at present, most households were eligible for a child allowance, since the income level that disqualified people from receiving such allowances was set quite high--at three times the minimum wage. There was also evidence of people receiving multiple pensions and pensioners remaining in the labor force.

The foreign exchange budget did not specify military expenditures and many subsidy expenditures, the staff representative explained. Most of the budgetary adjustment had taken place through the reduction of commodity subsidies, not military expenditures.

The staff representative from the Policy Development and Review Department stated that Azerbaijan had been declared International Development Association (IDA)-eligible--one of the conditions for ESAF eligibility. The staff was planning to recommend that Azerbaijan be declared ESAF-eligible. It was hoped that Azerbaijan would quickly graduate from the ESAF eligibility list, by virtue of the good prospects for economic growth offered by the oil sector.

Mr. Kiekens also expressed the hope that Azerbaijan, and similar countries, would graduate from the status of ESAF eligibility.

Mr. Al-Tuwaijri made the following statement:

> Internal and external developments played an important role in delaying the development of an economic transformation program in Azerbaijan. The STF program before us is a significant step toward laying the necessary foundations for a successful transformation of the economy. Indeed, economic developments in 1994, particularly the explosive rise in inflation, underscore the urgency with which a comprehensive reform program needs to be implemented.
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> There can be no doubt that the program before us is ambitious but subject to significant risks. Reducing such risks necessitates a front-loaded adjustment and reform effort. The strategy underlying the proposed program follows such an approach. The authorities have undertaken commendable steps, including the liberalization and unification of the exchange rate, the removal of bread subsidies, and the liberalization of domestic and international trade. I broadly concur with the staff appraisal and will therefore make only two general remarks:
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> First, the authorities face a dual and complex task on the fiscal front, namely, reducing the fiscal deficit while reviewing and reforming the revenue and expenditure systems. At present, the tax system gives rise to distortions, while the revenue collection system needs to be strengthened. Thus, I welcome the authorities' determination to remove export taxes and strengthen the revenue base. On the expenditure side, the introduction of a cash rationing system and quarterly monitoring should go a long way toward avoiding expenditure overruns. However, reform of the social safety net is essential for realizing the authorities' budgetary goals and promoting greater efficiency, and I welcome the authorities' intention to proceed with the development of a comprehensive package of reforms in this area.

The fiscal consolidation and reform process entails a number of uncertainties. The speed with which reform measures need to be implemented heightens this uncertainty. In view of the overriding importance of reducing the fiscal deficit, I would encourage the authorities to develop sufficient contingency plans to reduce the risk of divergence from the program targets.

Second, Azerbaijan is well endowed with natural resources that can provide a cushion in assisting the economic transformation process. However, to fully benefit from the country's natural endowments, a comprehensive strategy for structural reform needs to be established at an early date. I welcome Mr. Kaeser's indication that the authorities are committed to speeding up the privatization process on the basis of a program to be reviewed by the World Bank. The establishment of clearly defined property rights in land tenure must also receive high priority.

Finally, I agree with Mr. Kaeser that a case could well be made in favor of the inclusion of Azerbaijan on the list of ESAF eligible countries.

I support the proposed decisions.

Ms. Glennerster stated that she endorsed the positive reactions of other Directors to the program, including the set of prior actions.

The staff had made some commendably frank comments on the reasons for the low collection of customs duties in late 1994, Ms. Glennerster observed. That problem, and the implied corruption, were said to have been addressed in late 1994. She wondered whether the staff could comment in more detail on remedial measures that had been taken and on their success.

Given that financial sector reform was at a very early stage, she endorsed the comments of Mr. Desruelle on the cautious approach taken toward introducing indirect monetary instruments, Ms. Glennerster said. Since the auction market was likely to be very thin for a while, it would be necessary to monitor the results of the auction to ensure that real interest rates were kept positive. Many systemic transformation facility programs had suffered from unexpectedly high rates of velocity. Surges in velocity were not always triggered by exogenous shocks outside the control of the authorities, as was sometimes suggested, but the program's allowance for some increased velocity was welcome. Steady progress on reforming the financial sector and state-owned enterprises was essential to achieve the reduction in velocity that had been forecast in the staff paper.

She welcomed the fact that the authorities would not resist an appreciation of the nominal exchange rate, given the danger that capital inflows would increase the money supply, and the likely limited success of attempts at sterilization, Ms. Glennerster concluded.

Mr. O'Connor made the following statement:

During the Article IV consultation discussion last June, the Board expressed dismay over: the conflict with Armenia regarding the Nagorno Karabakh border region; the marginalization of the Azerbaijan National Bank as an effective instrument for financial policy, monetary control, and exchange rate management; and, the slow pace of general economic reform. We are pleased to note that by the end of 1994, the cease-fire negotiated with Armenia in May had been maintained and that the authorities in Azerbaijan had begun to adopt the Fund's view that substantial and immediate economic policy and structural reforms were required. It is unfortunate that further deterioration of the economy through 1994 and increasing severity of the balance of payments problem were the primary catalysts for the adoption of economic reform. Earlier action could have reduced the adjustment costs.

The authorities are to be commended for the impressive list of prior actions that have been initiated in the past few months. Most notable are the progress toward a final, and peaceful, resolution of the earlier conflict with Armenia and the restoration of effective powers to the central bank to formulate and manage monetary policy. The plan to formalize the central banking arrangements by midyear in new legislation indicates formidable progress. In addition, there are the elimination of multiple exchange rate practices in favor of a unified exchange rate, substantial liberalization of the trade regime, and price liberalization through the relaxation of administrative pricing on bread and oil.

The reform program indicates that there is still some distance to go with regard to price liberalization, privatization, trade reform, and financial infrastructure. Nevertheless, it is quite comprehensive. Moreover, the program is extremely ambitious with regard to the tight scheduling of reforms and with regard to the targets on the indicator variables for macroeconomic policy. Indeed, the disinflation target--from 50 percent per month at the end of 1994 to only 2 percent per month by the end of this year--may provide the incentive for a strong effort by the authorities but is clearly at risk as an achievable target for a number of reasons.

Substantial increases in commodity prices such as oil will underpin increases in industrial and consumer prices.

Public sector wage increases totaling more than 50 percent in the first half of 1995, followed by wage indexation with inflation targets thereafter, will provide a reference point for private sector wage negotiations. These wage increases will also feed forward into industrial and consumer prices.

Moreover, the drift associated with the inflation indexation of wages and the planned indexation of social security payments will complicate the task of the monetary authorities in reducing inflation expectations and in resisting credit demands from the government sector. Because the payment of wages and salaries receives first priority in the cash rationing mechanism, wage indexation imposes risks to fiscal spending restraint.

In addition to the inflation target, the monetary authorities must meet upper limits on domestic monetary base growth and lower bounds on international reserves, as well as manage the exchange rate under a confusing description of the exchange rate regime.

The exchange rate is first declared not to be formally fixed against the U.S. dollar, but the program assumes that it will be held stable in nominal terms. Yet, in the letter of intent, it is described as presently flexible. However, the flexibility is then defined in the staff paper as asymmetric, where nominal appreciation will be allowed to absorb some of the expected real appreciation. Finally, it is categorized in the letter of intent as being temporarily flexible with the ultimate objective of fixing its nominal value as an anchor for stabilization policy after the reform process has been more firmly established, the central bank strengthened, and international reserves rebuilt.

It is difficult to see how the monetary authorities can avoid some program slippage under this variety of targets for inflation, monetary growth, and the exchange rate. Indeed, there is the risk that none of the quantitative targets will be met as a result of the attempt to meet them all, even though technically they may be qualitatively consistent.

A simpler focus for policy would be more effective. I would therefore advise the monetary authorities to focus on only one quantitative target--the inflation target. A credible and determined effort to slow the rate of inflation by controlling tightly the growth of its domestic monetary base, while allowing full flexibility in the exchange rate and in real interest rates, is the best approach to achieving its objective of creating a low-inflation environment that is conducive to economic growth.

I will end my comments by urging the authorities to diligently pursue the scheduled program that they have formulated for structural reform, privatization, and fiscal control and wish them the best in this endeavor.

Mr. Coumbis made the following statement:

War, refugees, internal instability, and the disintegration of historical trading relations have seriously delayed

Azerbaijan's efforts toward stability and structural reforms. Developments in 1994 were disappointing in many respects, especially with regard to price developments. For 1995, developments look promising. The excellent prospects for a peaceful, permanent settlement of the Nagorno Karabakh conflict, the signing of an agreement with an international oil consortium, and the restoration of communication with Georgia and Chechnya constitute a substantial turnaround in the domestic and regional developments for this country.

Azerbaijan has requested a purchase under the systemic transformation facility, associated with a very ambitious program that, according to the staff, is feasible. In fact, there are many indications that this program will be successfully completed.

Prior actions in many important areas have been fulfilled. This effort, involving many extremely difficult and unpopular decisions on the part of the authorities, shows the Government's determination to carry out the adjustment process.

The cornerstone of the program is the substantial reduction of inflation, the increase of foreign exchange reserves to a satisfactory level, and the substantial reduction of the budget deficit. In the first two months of 1995, the monthly rate of inflation fell to approximately one half of the rate observed at the end of 1994. Moreover, 50 percent of the proceeds from the oil signature bonds will be used to strengthen reserves, and the manat counterpart will be used by the Government to finance the budget.

Parliamentary ratification of an agreement with an oil consortium last December for the development of off-shore oil deposits in the Caspian Sea has created excellent medium- to long-term prospects for the economy, provided that the authorities intensify their stabilization and structural reform efforts.

Slippages may occur in some areas of the program, however, unless further measures are taken, that is, in the area of interenterprise arrears, in view of their rapid growth and the danger of further accumulation stemming from the program's tight credit policies. Moreover, as concerns social safety nets, the removal of bread subsidies and other price corrections requires--apart from an increase in budgetary transfers in the order of 3-5 percent of GDP--a comprehensive package of measures in order to restructure the social safety net to make it rationally targeted. Furthermore, I agree with the staff that domestic and/or regional instability could undermine the authorities' objective and put the program off track.

The successful implementation of this ambitious program is an important step in the direction of stabilizing the economy and alleviating its structural problems. However, much more must be done in several areas if the authorities intend to pursue a stand-by arrangement with the Fund. The list of measures to be undertaken is impressive, and indicates that the authorities need to persist in their efforts in order to make their economy competitive in a free-market environment.

However, these efforts and the sacrifices that the population has to endure during the transition period are worthwhile because the economy's prospects in the medium to long term are excellent.

With these remarks, I support the proposed decisions. I join other Directors also in their request to include Azerbaijan in the list of ESAF-eligible countries.

The staff representative from the European II Department stated that corruption was a problem in the entire budgetary process, and not just in the customs administration area. The authorities had dismissed some government officials who were suspected of corruption and had begun criminal procedures against them. The authorities were determined to rid the public service of corruption.

The staff was dealing with the issue of the multiplicity of targets under the program, the staff representative said. The net domestic assets target, the reserve buildup target, and the reserve money target overlapped, and only in very specific circumstances would all of those targets be met. However, similar situations had existed in other countries in which there had been uncertainty about exchange rate policy, on the one hand, and the potential influx of foreign exchange, on the other. The staff was monitoring the target on the net domestic assets of the central bank and the reserve money target, because it feared the destabilizing impact of unpredictable and large foreign exchange inflows linked to the oil sector. The staff agreed with Mr. O'Connor that the number of performance targets could be reduced, once more experience was gained with the auction system--both for refinanced credit and for foreign exchange.

The staff's understanding was that the authorities would not intervene to deal with a large foreign exchange inflow, but would smooth daily fluctuations in the exchange rate that might result from it, the staff representative explained. In that regard, the staff was monitoring the level of foreign exchange. In the first quarter of 1995, the authorities had struggled with the difficult question of whether the incoming amount of foreign exchange was too high. They had decided to intervene in the market to prevent too strong a nominal appreciation from taking place.

The staff representative from the World Bank stated that the International Development Association (IDA) was considering a rehabilitation loan for Azerbaijan that had three components: the privatization program itself; financial sector reform; and social protection. That would be accompanied by a technical assistance loan--scheduled to be submitted to the Board before the rehabilitation loan--which included the analysis of large state banks. Such analyses were important in order to proceed with the financial sector adjustment loan operation, which would probably become operational in a year. The financial sector adjustment operation would deal with the banks' portfolios, which included loans to some of the largest loss-making enterprises. How the loss-making state enterprises were addressed would have a bearing on the scope of the financial sector adjustment activities as well. The rehabilitation loan would address bank prudential rules and the supervisory capacity of the central bank over commercial banks.

Mr. Kaeser said that he was grateful to the Board for having supported the request for a first purchase by Azerbaijan under the systemic transformation facility.

The Board decision was an historic one for Azerbaijan, a country eager to receive international support and recognition, Mr. Kaeser said. The first agreement with the Fund would allow Azerbaijan to make significant progress in the transition toward a market economy. The Azerbaijani authorities, in accepting the program prepared with the Fund, were fully aware that the success of the transition process was the key to economic recovery, social stability, and national independence. He would convey the comments and recommendations of Directors to the Azerbaijani authorities. In that regard, he had taken special note of the need to quicken the pace of privatization, to liberalize foreign trade, to avoid administrative delays, and to resist pressures from vested interests.

He agreed with Mrs. Wagenhoefer that lowering the budget deficit from 13 percent to 5 percent of GDP was less ambitious than it first appeared, because it stemmed from a substantial cut in military expenditure and large cuts in price subsidies, Mr. Kaeser noted. But if it was less ambitious, it was probably more realistic.

The main problem in economies in transition was that bankruptcy laws and procedures were in their infancy, Mr. Kaeser concluded. It was important to prevent virtually bankrupt enterprises from taking part in the credit auctions, because they could push interest rates to an artificially high level in the knowledge that they would not have to repay loans. In answer to the U.S. chair's question, Mr. Kaeser stated that the Azerbaijani authorities recognized the preferred creditor status of the Fund.

The Executive Board took the following decision:

1. The Fund has received a request by the Government of the Azerbaijan Republic for a purchase equivalent to SDR 29.25 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993), as amended.

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

Decision No. 10960-(95/41), adopted
April 19, 1995

2. FUTURE OF SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered the following statement by the Managing Director on the future of the systemic transformation facility:

During our meeting to review the operations under the systemic transformation facility (STF) on March 20, 1995, it was agreed that we would return to discuss the future of the facility before end-April 1995, when availability of first purchases under the STF expires. To provide a basis for such a discussion, this note summarizes the present situation regarding potential future use of the STF, discusses possible options for the facility, describes the legal considerations, and suggests a course of action. As Directors will recall, the STF was established on April 23, 1993, and amended twice: on July 29, 1994, the maximum interval between first and second purchases was lengthened from 12 to 18 months, and on December 14, 1994, the deadline for the availability of first purchases was extended until April 30, 1995.

1. Potential future use

Nearly all members that are potentially eligible for and possibly interested in using the STF will have made a first purchase by April 30, 1995 (Table 1). Although a very few other countries--Tajikistan, Turkmenistan, Afghanistan, Syria, and two successor states of the Socialist Federal Republic of Yugoslavia that are not yet members of the Fund--might eventually be interested in using Fund resources under the STF, it is unclear whether or when they might be in a position to qualify. Tajikistan, the only member that might be able to qualify in the next few months is also eligible for the ESAF, whose terms would be more suitable to its circumstances, and could, if necessary, make use of a first credit tranche arrangement as a step toward a more comprehensive arrangement. Several other members remain eligible for the STF but, to date, have shown no interest in using the facility. Most in this latter category, such as Albania, the Czech Republic, Hungary, Lao People's Democratic Republic, Mongolia, and Poland, currently have or have already had stand-by or ESAF arrangements; the few others, such as Slovenia, have the capacity to implement policies that could be supported by Fund arrangements should the need arise. Thus, the expiration of the availability of first purchases under the facility on April 30, 1995, would appear unlikely to have much, if any, effect.

Members that will have made a first purchase by April 30, 1995 have until end-December 1995 to make a second purchase, or until 18 months after the first purchase, whichever comes first. In all but two of the countries that will have made first purchases by end-April, discussions on policies that could be supported by follow up stand-by arrangements and second purchases under the STF are sufficiently advanced to suggest that second purchases could be made well within the applicable time limit. For the other two--Azerbaijan and Uzbekistan--the timing of a second purchase remains uncertain.

2. Possible options for the facility

Three options can be considered for the future of the STF: allow it to expire on April 30, 1995, as currently envisaged; extend it in its present form for an additional period; or extend it and augment access under it.

a. Expiration

The recent review of the STF has indicated a general view among Directors that the facility has served well its purpose as a "paving" mechanism. As noted above, very few additional countries seem likely to be in a position to take advantage of first purchases under the STF were it to be extended beyond April 30, 1995. Allowing the facility to expire would be consistent with its temporary nature and could reinforce incentives for countries to move to Fund arrangements as quickly as possible. Unless the deadline for first purchases under the STF was extended, it would also seem desirable to leave the end-1995 deadline for second purchases intact, so as to maintain incentives for rapid movement toward upper credit tranche arrangements in the few relevant cases. Extension of the end-1995 deadline for second purchases could be considered later in the year if that seemed warranted at the time.

b. Extension in its present form

Extension of the STF in its present form for a short period--say, to permit first purchases until end-1995--could possibly benefit a very limited number of members, such as Tajikistan and Turkmenistan. If the facility were extended in this way, it would be appropriate also to extend the availability of the second purchase beyond the new expiration date, say, until end-June 1996. In view of the difficulties that have been encountered in mobilizing financing in conjunction with stand-alone STF purchases, if there is a desire to extend the STF, I would ask Executive Directors representing creditors and donors and supporting that course also to express the intentions of their authorities to strengthen their efforts to assure that STF programs, including stand-alone programs, receive the necessary financial support.

c. Extension with augmentation

Extension and augmentation of the STF through provision for a third purchase would provide larger potential access to Fund resources for all members eligible for use of the facility and was a proposal under consideration in our discussions leading up to the Annual Meetings in Madrid. If this proposal were to be pursued, I would suggest in light of our earlier experience and discussion that any such augmentation be contemplated only in the context of upper credit tranche arrangements. I believe this would be in line with views expressed by most Directors on earlier occasions.

Since the earlier discussions, of course, the annual access limit under stand-by and extended arrangements has been increased by almost one half, and we now have considerably greater scope to address members' financial needs under the general access guidelines. Also, augmentation of the STF could reduce the incentive for members to move to comprehensive medium-term adjustment programs that could be supported by extended or ESAF arrangements on the same or better terms. In this connection, there are recent indications that some members, especially those that have entered into stand-by arrangements, are beginning to formulate programs in a more medium-term context. This is a favorable development that we should encourage.

3. Legal considerations

A decision to extend availability of a first purchase beyond April 30, 1995, or of a second purchase beyond end-1995, would require an 85 percent majority vote. Other features of the facility--for example, the level of access, the number and phasing of purchases, and the rule governing the interval between purchases--could be amended by a simple majority. If the period of availability of the first purchase were extended, as was done last December, during the period of the extension, a decision to increase access under the facility would require only a simple majority.

If the period of availability of the first purchase was not extended beyond April 30, 1995, access and other rules governing purchases under the STF by members that had already made a first purchase could be modified by a simple majority--such modifications would apply only to members that have made a first but not a second purchase by April 30, 1995. For members that made a second purchase before end-April 1995, the facility would expire on that date. Accordingly, additional access for these members could only be made available by a decision to reinstate the STF, which would require an 85 percent majority.

4. Recommended approach

After weighing the considerations involving the possible options, there would not appear to be strong arguments for extending the STF, and I would suggest that we permit the facility to expire. If, however, there are substantial concerns that a few potentially eligible members could be disadvantaged, extending the availability of first purchases for a short period, say, until end-1995, could be considered, but I would suggest this course of action only if there is a clear expression of intent by creditors to strengthen their efforts to ensure the necessary financial support. In that case, we should also extend the availability of second purchases to, say, end-June 1996. Regarding possible augmentation, we are now better positioned to address members' needs under our general access policies, and that would seem the preferable course.

Ms. Lissakers made the following statement:

As I stated in our review last month, we regard the systemic transformation facility as a true success for this institution. I will not repeat the points I made during the discussion, but I would note that approval of Azerbaijan's first STF this morning exemplifies once again that the STF has been both an important inducement to reform and a valuable and much-needed source of financing on terms that are more suitable than those available under regular Fund facilities.

It would be very nice to declare victory in the transition economies and close the STF window in the interest of rationalizing the institution's facilities, mechanisms, having fulfilled what was agreed from the beginning would be a temporary facility. We, and my authorities, have gone back and forth on this issue because there is considerable appeal to that approach which is preferred by management.

However, in weighing the options, we have come to the conclusion that the costs of keeping the window open somewhat longer are not high and that the benefits to a small group of countries are still potentially meaningful.

As discussed in more detail in the staff paper that was circulated last month (SM/95/49, 3/8/95), there are still a number of potential first-time users of the STF, both in the countries of the former Soviet Union and in several other areas, including the former Yugoslav republics. Those countries are still in transition and would, in fact, benefit from the lower conditionality and more concessional terms of the STF. I was somewhat surprised that the Managing Director did not mention the staff is scheduled to begin negotiations this week in Tajikistan on a program that could be supported by the Fund, potentially under an STF if it still exists. Conditions in Tajikistan would seem to call for the kinds of terms, maturity structure, and conditionality that are operational under the STF.

There are also a number of transition economies that have used the STF, particularly in the former Soviet Union, that continue to face extraordinary adjustment requirements as they complete their transition. It is premature to declare the period of transition over. Despite strong adjustment efforts, some of these countries may also continue to face extraordinarily large external financing needs. In that case, the strategy we are proposing as an alternative to the STF would be to go to stand-by arrangements, then to an extended arrangement, but it is not clear that all of these countries will be able to move into an extended arrangement. The STF maturity structure is a very important asset. In a situation in which, instead of an extended arrangement, we had one, two, or three stand-by arrangements in a row because the financing needs were so great, and we did not have another option consistent with our conditionality, having available instead an STF with long maturity could be of considerable benefit. Otherwise, we face the problem of a very troublesome bunching of maturities on some of these claims.

The terms for STF resources are both preferable and a good complement to a stand-by arrangement. Some countries are eligible for an ESAF, but not all of these countries qualify, and might not, in fact, be ready in time for the more extensive commitments required for an extended arrangement. Thus, while the terms of the systemic transformation facility and the extended arrangement are comparable, I do not think one can regard them completely as interchangeable sources of financing.

As the transforming economies face very immediate adjustment and financing needs, the front-loading of the STF is also perhaps particularly useful and will continue to be useful for some time to come. Therefore, our preference would be to extend the STF perhaps through the end of the year, at least, to keep the option on the table and see how the situation evolves. There is still sufficient uncertainty about how some of these transition countries will move and how forcefully their adjustment process will be carried forward. We would favor a corresponding extension of the period for making a second purchase to end-June, perhaps, of 1996.

I am particularly interested in comments or reactions by Messrs. Kaeser, Kiekens, and Wijnholds, as they represent many of

> the countries in question, regarding the Managing Director's statement, or my comments. I would be surprised if their constituents favored termination of the STF at this point in view of the instrumental role it has played and the high degree of uncertainty that still surrounds the transition process, including the financing aspect. I would reiterate that there are, in fact, several countries that still have not made any use of the STF and that are at least potential candidates for the program.

The Chairman agreed with the arguments made by the U.S. chair. His proposals were just that--proposals, which could be modified; for example, a decision to extend the facility to end-1995 for the first tranche and to end-June 1996 for the second tranche could be considered. The Executive Board should examine all of the options before making its decision.

Mr. Geethakrishnan, noting the three options in the Managing Director's statement--expiration of the facility, extension of the facility in its present form, and extension of the facility with augmentation--remarked that he had not expected the option for extending the facility with augmentation to be considered. During the last discussion on the STF, the General Counsel had interpreted the mandate from the Interim Committee to the Executive Board on the SDR and the STF package as being to decide either to extend the facility or augment it, but not both. Therefore, unless the Interim Committee revised the mandate, only the first two options--expiration of the facility or extension of the facility in its present form--should be considered.

The Chairman's assessment had been that those countries needing the facility were aware of its availability, while those countries that had failed to take advantage of it perhaps did not need it, Mr. Geethakrishnan said. Ms. Lissakers had indicated that Tajikistan could access the facility, and the Chairman had said that Tajikistan was the only Fund member that might be able to qualify in the next few months. However, the Chairman had also said that Tajikistan was eligible for better terms under the enhanced structural adjustment facility (ESAF). Further comments from the staff on Tajikistan's potential to qualify for different Fund-supported programs would be appreciated. While the Chairman had remarked that his views were not intended to be unyielding, his tone was clearly to recommend expiration of the facility--a recommendation that he could endorse.

The Chairman said that he recognized that the STF had the potential to lead economies toward the ESAF--although that was not essential in the case of Tajikistan. He looked forward to a consensual decision on the STF.

Mr. Ismael made the following statement:

> There is no change in my chair's position with regard to the STF. The facility has indeed successfully served its purpose, as reflected in the number of countries graduating from this facility and entering into upper credit tranche arrangements. Therefore, I

see no compelling reason for its extension. My chair supports the Managing Director's recommendations to allow the expiration of the STF.

As pointed out in the Managing Director's statement, the financing needs of members, which qualify for but have not made use of the STF, could be adequately dealt with through the use of other existing Fund facilities.

In addition, current evidence shows that these facilities have been more successful in playing the catalytic role than the stand-alone STF. Therefore, the sooner the remaining countries enter into Fund arrangements with strict conditionality, the sooner there will be a more positive response from bilateral and multilateral donors.

Mr. Mozhin, noting that there were potential beneficiaries of the STF whose access would be eliminated, said that he favored extending the systemic transformation facility until end-1995 under option B. The ESAF could not be considered an alternative in the case of Tajikistan, as the country might not be prepared for it. Four countries had only recently obtained the first tranche of STF resources; as it was unclear whether they would be able to purchase under the second tranche on schedule, he could support extending the deadline for the availability of second tranche until mid-1996.

Mr. Schoenberg made the following statement:

We basically share the Managing Director's view that the arguments for extending the STF do not seem very strong any more. Nearly all members--the last one being Azerbaijan--that were potentially eligible for and possibly interested in using the STF have made a first purchase before the extended deadline for its availability, and many members have, in addition, entered stand-by arrangements. The facility has indeed served well its purpose of a "paving" mechanism, and after 2 1/2 years one could argue that the requirement of "temporariness" has been met. With respect to the few remaining eligible countries, it is still somewhat unclear to what extent these countries would be interested in using the facility and whether interested countries might be in a position to qualify for a purchase under the STF. Therefore, like Ms. Lissakers, I think it might be helpful if Directors representing likely candidates would express their view on the need and the prospect for qualification of those member countries.

If it were the opinion of other Directors, however, that an extension of the STF in its present form would be beneficial and preferable in order to permit first purchases until end-1995, we could go along with that option, too, particularly if the chair representing transformation countries that have not yet made use of the facility would express a strong desire to see the facility extended. I would like to stress, however, that we would not see a linkage between any extension of the STF and increased financing obligations by potential creditor countries. Creditors have undertaken to use "their best efforts" to help close any remaining financing gaps, and my country would certainly continue to make such best efforts. Creditors have not undertaken, however, to "ensure the necessary financial support" as requested by the Managing Director, and I would be surprised if they would in future.

Regarding the third option a possible augmentation, I tend to agree that we are indeed better positioned now to address members' needs under general access policies. In view of the fact that many Directors have suggested that any augmentation should be contemplated only in the context of an upper credit tranche arrangement, the case for an augmentation of the STF does not appear strong any more.

Mr. Kiekens said that he agreed with Ms. Lissakers and Mr. Schoenberg that the systemic transformation facility had satisfied expectations. Since its approval two years earlier, the facility had enabled economies in transition to move quickly toward policies that could be supported under upper credit tranche arrangements. With Azerbaijan having received Fund support under the STF, there remained few members who might be interested in using the facility; and, indeed, some speakers considered that Tajikistan might be the only remaining candidate to qualify. Staff comments on that topic would be appreciated. Therefore, support for the proposal not to extend the STF beyond April 30, 1995 would be consistent with the temporary nature of the facility.

As systemic transformation would take time, many transition countries would continue to require strong financial and technical support from the Fund, from other multilateral financial institutions, and from creditor countries. Mr. Kiekens said. Comprehensive medium-term programs would be required that could be supported initially by stand-by arrangements and, thereafter, by an extended Fund facility or, for the poorest transitional economies, by the ESAF. In that connection, the augmentation of the STF with a third tranche in parallel with a stand-by arrangement might reduce the incentive for members to undertake or implement medium-term programs that could be supported by the EFF. That seemed to be the case for Belarus and, especially, Kazakhstan. Both countries had received two tranches under the STF. Kazakhstan firmly intended to obtain an extended arrangement, and it was hoped that, after some success with the stand-by arrangement, Belarus would also undertake a program supported by an extended arrangement instead of the more easily-obtained funding through the STF.

Management and the Executive Board should continue their strong commitment to transitional economies under the existing Fund facilities as well as in the form of technical assistance, Mr. Kiekens concluded. Such support should catalyze equally strong support from other multilateral financial institutions and creditor countries. There could be no doubt that progress in that area would benefit the entire membership.

Ms. Lissakers stated that she would like to keep open the option for augmentation of the facility. Permitting the STF to continue operating, while monitoring the developments of candidate countries, was the desirable course of action. For the reasons outlined by Mr. Schoenberg, augmentation was not a realistic option at present; however, its future consideration was desired.

The Chairman asked Ms. Lissakers whether she would accept a decision on the issue of possible augmentation if there was a consensus among Directors.

Ms. Lissakers replied that strong agreement in the Board was both necessary and desirable. Retaining the option for augmentation of the facility was justified on the basis of the current problems experienced by economies in transition, the expectation that their future financing needs was going to be large, and the uncertain pace of their economic reforms. Mr. Kiekens's view--that it was desirable to pressure countries to move quickly to high conditionality programs, such as extended arrangements, stand-by arrangements, and ESAF arrangements was correct. However, that approach might not work in every instance, and a stand-by arrangement might then be a country's only recourse. However, such a strategy would be costly and not contribute significantly to economic reform. Experience showed that the pace of reform proceeded unevenly, and that some economies progressed faster than others--although it was to be hoped that the learning curve had shortened somewhat.

Mr. Link made the following statement:

> This chair could go along with either the first or the second option outlined by the Managing Director.
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> Two members of our constituency--Tajikistan and Turkmenistan--might be interested in making purchases under the STF. Two other countries of our group--Azerbaijan and Uzbekistan--have made a first purchase this year and could be interested in an extension to make a second purchase beyond the end of 1995. We are therefore ready to associate ourselves with a decision extending the availability of a first purchase until end-1995 and the availability of the second purchase until end-June 1996. We are also ready to make our best efforts to mobilize additional financial support.
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> At the same time, the arguments on the basis of which the Managing Director draws the conclusion that we could permit the STF to expire show that the expiration of this facility would not create great harm to any country. Tajikistan could make use of the first credit tranche before requesting an ESAF arrangement.

Turkmenistan could do the same before entering into a stand-by arrangement. As suggested by the Managing Director, extension of the end-1995 deadline for second purchases could be considered later in the year, if that seemed warranted at that time.

This chair is clearly against the third option, namely, the extension combined with the augmentation.

The fact that the annual access limit under stand-by and extended arrangements has been increased by almost one half--thereby creating greater scope to address members' financial needs under the general access guidelines--constitutes a convincing argument against augmenting the STF to include a third tranche. In any case, if the Fund wished to give serious consideration to increasing access to the STF, we feel that this should only be done if a full analysis of the likely impact of such an operation on the Fund's financial situation were to be carried out. The extent to which rapidly rising risk exposure of the Fund through credit concentration in transition countries can be considered to be acceptable, would have to be carefully examined is this context.

The Managing Director's statement refers to the fact that substantial difficulties have been encountered in mobilizing financing in conjunction with stand-alone STF purchases. The reluctance of bilateral donors to support STF programs could indeed reflect a perception that stand-by arrangements, with their accompanying conditionality, are highly preferable to these programs.

Mr. Lanciotti made the following statement:

Let me start by saying that the approach recommended in the Managing Director's statement is quite reasonable. Indeed, almost all eligible countries have already taken advantage of the STF; moreover, the Fund, after the augmentation of access under stand-by and extended arrangements, is now well positioned in terms of general access policies to cope with members' needs. As a consequence, there are no decisive arguments in favor of an extension, let alone augmentation, of a facility that is temporary in nature.

Meanwhile, I also see some merit in the second option as eloquently described by Ms. Lissakers, namely, extension without augmentation. In fact, during the March 20 discussion, I observed that the facility has proved to be an appropriate tool to deal with the special needs of the transforming economies and, by and large, has performed reasonably well its role of "paving the way" toward more comprehensive arrangements. In this light, those few countries that have not yet benefitted from the STF could consistently be offered the same possibility.

In conclusion, the facility could be allowed to expire at the end of the month. However, I do not oppose the alternative that the deadlines for the first and second purchases be extended within limits, without any augmentation, should this view be shared by a broad majority of the Board.

Mr. Havrylyshyn considered that the systemic transformation facility had well served its purpose to pave the way toward upper credit tranche arrangements for many economies in transition, and programs had become stronger than expected in many cases. The only remaining question was whether the facility would be allowed to continue. A large number of countries in his chair's constituency were particularly appreciative of the STF contribution toward facilitating macroeconomic stabilization and structural reform. One of the successor states of the Socialist Federal Republic of Yugoslavia--a country that was not a member of the Fund, but was informally looked after by his chair--would also be interested in the availability of STF resources.

While ensuring the temporary nature of the facility was important, termination of the STF could be costly to the economies of eligible member countries that might miss the opportunity to make use of the facility, Mr. Havrylyshyn commented. The key argument for recommending option A, allowing expiration of the systemic transformation facility, had been noted in the Managing Director's statement: "Expiration of the availability of first purchases under the facility on April 30, 1995 would appear unlikely to have much, if any, effect." While the statement was correct, the inverse was also true: an extension until end-1995 would be unlikely to have much effect, because there were very few potential members that could make a purchase. However, an extension had two important advantages over expiration: first, it would be fairer to recognize that delays in the transition process were much longer than had been envisioned two years earlier; second, any drawing on the STF would benefit greatly recipient transition economies. Thus, there seemed to be little cost in allowing the remaining countries that opportunity. For those reasons, option B--extension of the STF in its present form to end-1995 and of the second tranche drawings to mid-1996--was preferred.

The STF and extended arrangements were not equivalent, Mr. Havrylyshyn said. The advantages to the STF were offset by the loss of incentives to pursue extended arrangements. However, many of the authorities represented by Mr. Tulin's chair had indicated the importance of pursuing other arrangements. Therefore, less weight should be placed on the arguments in favor of augmentation than on leaving open the opportunity for remaining member countries to use the STF. Of course, consideration of augmentation would have to be based upon a strong consensus.

Mr. Mesaki made the following statement:

> This morning the Board approved Azerbaijan's request for a purchase under the systemic transformation facility, and now it could be argued virtually all the envisaged candidates have received approval of their requests for purchases under the facility. The systemic transformation facility has played a very important role in supporting the economic reform of countries in transition, and the time has now come to draw the curtain and bid it a warm farewell.
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> I would suggest we attach more importance to conditionality, an essential safeguard of the Fund's resources. Protracted use of the systemic transformation facility, especially extension and augmentation, could be incompatible with this important principle of the Fund.
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> In view of the recent substantial progress in the economic reform of the countries in transition, I believe that the future financial needs of those members could be--indeed should be--addressed by the general access guidelines, which means higher access for a stronger program.
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> In conclusion, I support the proposal to allow the systemic transformation facility to expire.

Mr. Sirat stated that the Board decision in December 1994 to extend the systemic transformation facility for four months had been correct, since several countries had benefitted from the facility during the first months of 1995. Although unconvinced of the wisdom of again extending the STF, a further extension would be acceptable if it appeared that a large majority of the Board supported the limited extension under option B. In that connection, he shared Mr. Havrylyshyn's assessment that the costs of prolonging the systemic transformation facility until end-1995 would not be high.

In listening to those representing constituencies that included potential beneficiaries of the STF--most notably Mr. Link--it was apparent that all countries that could benefit from the STF had not already done so nor would be able to do so by end-1995, Mr. Sirat said. On the other hand, there was a precedent for terminating the STF, inasmuch as allowing the facility to expire would demonstrate the success of the Fund's strategy regarding economies in transition. Since there might be difficulty for some countries in drawing the second purchase at end-1995, a reconsideration of the issue at that time would be appropriate.

Regarding the possible increase in access to Fund resources through a drawing on the STF in tandem with a stand-by arrangement, as had been suggested by his chair in March 1995, that approach could be achieved through changes in access limits on stand-by and extended arrangements, rather than through an extension of the STF, Mr. Sirat concluded.

Mr. Kang agreed that the systemic transformation facility had served its purpose well as a paving mechanism to help member countries move quickly to higher credit tranche arrangements. In view of the lack of demand for the STF, allowing expiration on April 30, 1995 was the preferred course. Such a step would be consistent with the original intention that the facility be temporary in nature, and it might reinforce the incentive for countries to move to other Fund arrangements more quickly. In general, the Fund, whenever possible, should consolidate the number of financial facilities available. In addition, the end-1995 deadline for second tranche purchases should remain intact, and reconsideration of extending that deadline should be addressed later in 1995 if necessary.

Mr. Shields stated that he tended to share the Chairman's view. The systemic transformation facility had served its purpose well, and, since it was envisaged as a temporary facility, it was proper to terminate it at some point. Also, it looked as if possible further use--either for a first purchase or a second purchase--would not materialize. Therefore, the argument was strong for terminating the STF at end-April.

On the other hand, it seemed important that the potential use of the STF--either for the remaining cases or for possible second drawings that might need additional time--not be withdrawn, Mr. Shields remarked. In that connection, Mr. Havrylyshyn's point about the cost of keeping the options open longer was valid. Therefore, either option would be satisfactory. It seemed that the Board was leaning toward some limited extension, as outlined in the second option.

Some concerns about financing assurances in the event of an extension had been mentioned, Mr. Shields said. One of the possibilities that the Chairman apparently had in mind was the view of the European Union. Since its position apparently was that financial assistance would be limited to support for upper credit tranche programs only, it would not be wise to rely on financing assurances from them.

The Chairman replied that he failed to understand Mr. Shields's reference to financing assurances. Some STF participants had lost the momentum to continue reforms and had preferred, instead, to wait before applying for a stand-by arrangement. It would be costly not to help those countries to embark on an STF with its potential for paving the way toward a stand-by arrangement .

Mr. Shields replied that he had only assessed the current position of the European Union concerning financial assistance and was not speaking to any future policy of the European Union on that issue.

Mr. Sirat noted that, at the level of the Council of Ministers of the European Community (ECOFIN), the European Union had discussed balance of payments support for economies in transition in recent months and had decided that such support should be disbursed only in the context of upper credit tranche arrangements.

Mr. Calderón stated that like Mr. Shields, he found it difficult to take a firm position. The systemic transformation facility had indeed fulfilled its purpose. The Managing Director's statement clearly noted that: "Nearly all members that are potentially eligible for this facility would have made a first purchase by April 30..." No compelling reason for extension beyond April 30, 1995 had been put forward. He could not agree with the view expressed by Mr. Havrylyshyn that extending the STF would appear unlikely to have any effect; on the contrary, the termination of the facility would have quite a significant effect in that it would set a precedent that the Board could end or abolish a transitory facility.

While incentives for countries involved in the process of making second purchases should be retained in order to allow them to complete their purchases within the prescribed time period, the Board should also be willing to extend, if necessary, the second tranche deadlines, Mr. Calderón continued. In addition, there were indications that some member countries using the STF were beginning to formulate programs in a medium-term context. Augmentation of the STF would be contrary to the long-run objective of enabling members to move to medium-term adjustment programs that could be supported by extended or ESAF arrangements. In that context, one could only agree with the Managing Director's assertion that such a step would reduce members' incentives to move quickly toward other Fund arrangements.

Mr. Al-Tuwaijri made the following statement:

> Briefly, in your well thought out statement you have used three possible options and conclude that permitting the systemic transformation facility to expire would be the preferred approach. Based on the convincing arguments in the statement, I concur with this conclusion.

Mr. Berrizbeitia, noting that the Managing Director's statement had clearly indicated that there were no strong arguments for extending the systemic transformation facility at present, supported the recommended approach, decided in December 1994, to allow the facility to expire at end-April. The purpose for extending it through April 30, 1995 had been met with the accession of two countries--including Azerbaijan that day--to the STF since end-1994. As clearly noted in the statement, the remaining members who would likely qualify for the STF were--for different reasons--unlikely to use it. In that context, the staff's opinion regarding the likelihood of Tajikistan using the STF instead of an ESAF arrangement would be appreciated, especially since the ESAF arrangement appeared to be more attractive.

If the Board was to agree to an extension at the present meeting, it would again be faced with a decision on another extension in December 1995, Mr. Berrizbeitia said. At that time Directors would argue that still more time was necessary for one or two countries that had not made use of the facility by end-1995. Therefore, a permanent STF was very appealing. On the other hand, the evidence indicated that one of the original purposes of the STF--that members that had made use of the facility would increasingly be able to access other Fund arrangements--was being fulfilled. If, as Ms. Lissakers had suggested, the circumstances warranted a later review, the Board could always reconsider the issue from a fresher perspective.

The STF had served the membership well, but extension of the facility was unnecessary, Mr. Berrizbeitia commented. Directors, including those that represented transition economies, recognized that allowing the facility to expire would be consistent with its temporary nature and would reinforce incentives for countries to move to other Fund arrangements as quickly as possible.

Therefore, he opposed extension of the STF, Mr. Berrizbeitia stated. Other mechanisms might be able to serve future needs. The Board should be reluctant to reopen a debate that had already been decided--especially a few days before the meeting of the Interim Committee. Although some Directors had indicated a secondary preference for option B, most seemed to prefer allowing the facility to expire. That decision was appropriate.

Mr. Clark reiterated his March 1995 view that the STF had achieved most of what it had been intended to do and should therefore be phased out. However, given the arguments by Ms. Lissakers, Messrs. Mozhin, Havrylyshyn, Link, and Shields, and several other colleagues, there was no need to hurry the process. Therefore, he recommended an extension to end-1995 with the understanding that any augmentation should proceed only with a strong majority of the Board.

Ms. Lissakers, commenting on Mr. Berrizbeitia's statement that the STF could be revived if needed, stated that such an approach would create difficulties for the staff--guided in its policy dialogue with countries on the basis of existing program and facility options. Under those circumstances, a delay in concluding any negotiations might be the best possible outcome, since recreating a facility--prematurely terminated--would impose a higher cost than would retaining the facility for a short period of time.

Mr. Berrizbeitia stated that the available information suggested that practically none of the eligible countries would access the STF. That being the case, the Board would be in a position to evaluate the facility from a fresh perspective should its potential for use by economies in transition warrant a review by the Board at some later date.

Ms. Lissakers replied that her position to extend the STF had been based on three considerations: there was at least one outstanding potential user of the facility in Tajikistan; there were some countries that had used the first tranche and that might not be able to draw on the second tranche before the end-1995 termination date; and there might be a potential role for a facility augmentation for countries already making use of first and second STF tranches.

Mr. Bergo made the following statement:

> As many speakers have observed, the systemic transformation facility has served a useful role as a paving mechanism for a normal Fund arrangement and, as most eligible countries have made use of the facility, it can be said to have largely fulfilled its role.
>
> Tajikistan seems to be the only one of the remaining countries that might qualify for an STF arrangement in the near future. But, Tajikistan is also eligible for the ESAF, which should be a more suitable facility for that country. I doubt whether an extension until the end of the year will enable more countries to make use of the systemic transformation facility. And the prospect of a series of extensions, which could be argued using the same arguments as we hear today, is not a very attractive one. I find it important that a facility designed to be temporary also be kept temporary. Also, the temporariness of the facility was part of the incentive structure built into it. An extension would reduce the incentives for members to move quickly to medium-term adjustment programs.
>
> Furthermore, the stand-alone STF purchases have generally proved to be insufficient in catalyzing external financing thus far, and, as a result, the Fund has been exposed to unusual risk. This apparent reluctance of the other creditors to ensure the necessary financial support for STF arrangements also indicates that the systemic transformation facility's time has passed. I can see no strong reasons for extending the facility. With regard to augmentation, I would be very skeptical, as this would add even more to the considerable risk the Fund has already been exposed to under this facility.

Mr. Havrylyshyn said that he wished to support those Directors who had stressed the temporary nature of the systemic transformation facility. In that connection, the real question was whether two years or some longer period of time might be the right amount of time needed; that consideration should rest on the principle of fairness in the context of recent experiences of economies in transition.

Mr. Schoenberg commented that it could be argued that fairness, in the current context, might mean when a country embarked on a transformation process within a specified time. Regarding temporariness, there had been Fund facilities that had been extended more often and for longer periods of time than the STF. In that connection, those Directors who had supported the temporariness of the STF should remember that argument when discussing another extension of the ESAF.

The Chairman replied that the STF was not self-sustaining, and, for that reason, it differed from the ESAF.

Mr. Mirakhor expressed his disappointment that an alternative option had not been proposed--extension of the STF plus an SDR 36 billion general allocation. The arguments of Mr. Havrylyshyn and others had persuaded him of the wisdom of extending the facility. Although the Board discussion had mentioned only republics of the former Soviet Union, including Tajikistan, it was important to recall that other member countries outside the Baltic countries, Russia, and the other countries of the former Soviet Union might also take advantage of the facility--for example, Afghanistan, a country in Mr. Kaeser's constituency. Once the Afghan civil war subsided, the economy would immediately be in need of a facility like the STF. Although ESAF-eligible, Afghanistan would not be in a position to formulate, nor would it be capable of supporting, a program under the strict conditionality of ESAF; and neither would Tajikistan.

The Chairman described Afghanistan's situation as relevant to the STF and urged Directors to consider such countries in their deliberations.

Mr. Wei stated that he could support option A--termination of the facility by end-April--for the reasons given in the Managing Director's statement. The Board should consider extending the date for the second purchase of the STF. Despite sharing the concerns of Mr. Mirakhor and other Directors, he understood that countries, such as Tajikistan and Afghanistan could--when circumstances warranted--request Fund assistance under the ESAF.

Mr. Saito said that, in view of the temporary nature of the STF, his chair preferred that the facility should expire at end-April 1995. However, his chair was willing to consent an extension of the STF in its present form until end-1995, for the first purchase, and until end-June 1996, for the second purchase.

Mr. Obame stated that his chair joined other Directors in recognizing the positive role that the STF had played as a paving mechanism in assisting economies in transition. Although his initial position had been to allow the facility to expire, the statements made by Mr. Havrylyshyn and Mr. Mirakhor had convinced him that a limited extension--to allow some Fund members currently accessing the facility to draw their second tranches--would be appropriate. After the STF expired, an interim enhanced structural adjustment facility should be proposed with suitable terms for economies in transition.

Mr. Jones stated that the Managing Director had made a strong case in his statement for terminating the STF, but, after listening to the remarks made by some Directors, he favored an extension of the facility.

The Deputy Director of the Policy Development and Review Department stated that when the STF had been established, the importance of ESAF-eligible economies moving quickly to the ESAF had been recognized--not only because of the program's medium-term orientation but also because of its more favorable terms--for example, while the maturities were essentially similar under both programs, the interest rate was much lower under the ESAF.

The current mission to Tajikistan had begun its discussions on an STF program, the Deputy Director said. The intention had been to proceed with the first credit tranche program and then to move quickly to an ESAF arrangement; however, there had been no indication when those negotiations would conclude.

The Chairman reminded Directors that their decision on the STF would require an 85 percent majority, and he asked the Secretary for a "count" of Directors.

The Secretary stated that nine Directors favored the immediate termination of the facility; seven Directors favored extending the STF; six Directors did not state a strict preference for either option; one Director had not participated in the debate; and one Director had not yet given an opinion. On that basis, the 85 percent majority needed for an extension of the facility was not within reach.

The Chairman recommended that a decision for termination of the facility be considered and requested comments from Directors.

Mr. Schoenberg reminded Directors that his statement had emphasized the views of those Directors representing countries eligible for the STF. After listening to the remarks by Mr. Link and by Mr. Havrylyshyn, he now favored an extension of the STF until end-1995.

The Chairman noted that Mr. Schoenberg's decision had shifted the balance, and that only two options had retained Directors' support thus far: the immediate termination of the facility and extension of the facility to end-1995 with an additional six months provided for countries not yet having drawn their second tranche. Although Ms. Lissakers had recommended augmentation of the facility as a future possibility, it had not received much support. Mr. Havrylyshyn had mentioned that countries in his constituency and elsewhere could benefit from an extension, but that the extension should be followed by termination thereafter. Mr. Sirat's suggestion to utilize the exceptional access on stand-by and extended arrangements--instead of creating a third tranche in very exceptional cases--was another option available for consideration.

The Chairman remarked that Mr. Calderón's suggestion to modify the text for an extension of the facility appeared to have been what Mr. Havrylyshyn had had in mind.

Mr. Al-Tuwaijri stated that his sense was that the Board preferred terminating the facility.

Mr. Bergo, being reassured that there would be no additional extensions, said that he could agree with an extension until end-1995, although he did not see its purpose.

Mr. Berrizbeitia stated that he understood that the Board could legally extend the systemic transformation facility without augmentation, as outlined under option B. Furthermore, the Board was authorized to extend the facility through end-1995 and, as suggested by Mr. Sirat, could deal with exceptional circumstances as they arose--the situation he had envisioned when suggesting a future review of economies in transition and their options under Fund-supported programs. Given those considerations, he could agree with the extension of the STF until end-1995.

He wondered whether the systemic transformation facility or the ESAF was the more attractive alternative for countries like Afghanistan, Mr. Berrizbeitia said. The staff's description of the ESAF in the context of Tajikistan did not make the ESAF seem any less attractive than the STF. Although the situations in Tajikistan and Afghanistan were somewhat different, the relative attractiveness of the ESAF versus the STF was an important consideration for such countries, since, as Mr. Bergo had stated, it was unlikely that they could utilize the STF until end-1995.

Ms. Lissakers remarked that, in consideration of Afghanistan's potential use of the facility, it seemed presumptuous for the Board to prejudge the facility in that case, when such a decision could be made more sensibly in December 1995.

The Chairman replied that he was trying to eliminate the risk of leaving the decision open-ended.

Ms. Lissakers stated that she understood the Chairman's reasoning, and that a straightforward decision on extending the facility was desirable. However, she wondered whether the decision to deny the Board the right to change its opinion in December would be legally binding.

Mr. Al-Tuwaijri said that Ms. Lissakers's comment offered a strong argument for terminating the facility, since the Board, given the option of extending the facility, might run the risk of establishing a permanent facility.

Mr. Ismael agreed with Mr. Al-Tuwaijri.

Mr. Shields expressed his preference for an extension of the STF, adding that he wished to emphasize that general access limits should be increased and that "exceptional circumstances" should remain exceptional.

Mr. Geethakrishnan recalled that the Managing Director had concluded that the facility could be terminated, and said that that alternative was based on the notion that countries needing access to the facility had already received it, while countries that were not yet eligible did not require its assistance. In the case of Tajikistan, the Chairman had argued that those countries ineligible for the STF would be ESAF-eligible. Directors had heard Mr. Havrylyshyn remark how STF conditionalities were at least as strict as those for the ESAF. The Managing Director's argument was also puzzling, given that some economies in transition might still be eligible only for the systemic transformation facility but not for the ESAF. He wondered why some Directors felt that Tajikistan might not be able to qualify for the ESAF.

The Deputy Director of the Policy Development and Review Department said that if a country could move quickly to the ESAF and qualify for its highly concessional terms, then the ESAF was preferable to the STF. However, it was important to determine whether a country could quickly articulate a three-year structural adjustment program under the ESAF with all its requirements.

Regarding conditionality, Mr. Havrylyshyn had noted that some of the requirements under the STF were ambitious, the Deputy Director recalled. The STF posed a different type of conditionality from the ESAF or the EFF. In general, the STF was not as comprehensively drawn nor did it have the medium-term orientation required of the ESAF. However, the first credit tranche of 25 percent and charges under the ESAF and the STF were identical.

Mr. Mirakhor considered that it was perhaps unfair to ask the staff whether the conditionality of one type of program was softer than another. The operative word in the staff response about the ESAF program was "qualify"--meaning that the country had to be in a position to negotiate a three-year program, including the details of its conditionality. Directors were aware of the tough nature of ESAF programs. Having personally moved two countries into the ESAF and having worked with the Fund-supported program for a long time, he believed that STF conditionality and financial terms were somewhat better. Countries experiencing civil strife, such as Tajikistan and Afghanistan, would not be able to assemble the required management team in time to devise a three-year, medium-term program.

Mr. Berrizbeitia remarked that, given the stronger arguments on the virtues of the STF, vis-à-vis the ESAF, he had been surprised that the Managing Director had not offered an option of extending the facility for a period longer than nine months--perhaps even making the facility permanent--since the likelihood that any candidate for the STF would be able to use it before end-1995 was slight.

The Chairman replied that the STF had been established as a temporary facility, and that, under normal circumstances, the Board would allow it to expire. There remained a few countries that could marginally profit from its extension--and at low cost until end-1995. However, the facility was designed to be no more than a temporary mechanism.

Ms. Lissakers proposed modifying the Managing Director's statement by replacing the reference to the facility's design as temporary with language reflecting that the facility had been designed to meet the needs of countries undergoing a fundamental process of transition from one economic system to another with simultaneous changes in the political structure. The fact that administrative and economic capacities of those countries had been ill-suited to qualify for standard Fund-supported programs should also be recognized. It seemed that Directors favoring expiration had indicated that the period of transition was over, and that countries for whom the STF was created no longer needed it; however, that argument was not persuasive.

Mr. Geethakrishnan said that Board consideration of the Chairman's statement had demonstrated the statement's ambivalence. In addition, the Chairman's views appeared to him to have changed during the discussion, as the Chairman's statements now suggested that economies in transition could not graduate to the ESAF. The Board discussion had included several interesting points at odds with the option to allow the facility to expire: the staff observation that, while Tajikistan could not qualify for the ESAF, it still might want access to the STF; Mr. Mirakhor's point that civil strife, in the case of at least two countries, indicated that the STF needed to be extended by a longer time period--perhaps two or three years instead of nine months; and Mr. Berrizbeitia's argument for a permanent extension. If management's assessment of the facility's usefulness to those countries had changed, the Board should be informed of it, since such countries could not qualify under other Fund-supported programs. If in those circumstances the STF was to be the only remedy for those strife-torn countries, then an extension of three or six months would be insufficient. The facility would need to be extended for a longer period.

The Chairman reminded Directors that he had explained his legal and other reasons for recommending termination of the facility. As the 85 percent majority required to extend the facility had not been achieved, he concluded that the Executive Board had decided that the facility should expire on April 30, 1995, with the understanding that the end-1995 deadline for second purchases had been left intact.

The Deputy Director of the Policy Development and Review Department replied that he had not suggested that some countries could only qualify under the STF. The staff was working toward a first credit tranche purchase for Tajikistan--to be followed quickly by an ESAF. If the STF were available, then it could be of use to Tajikistan; if the STF were to expire, the first credit tranche of the ESAF would still be available.

The Executive Board then took the following decision:

The period of the systemic transformation facility is not extended. In accordance with the terms of the decision establishing this facility, the period within which a member may make a first purchase will expire on April 30, 1995. With respect to members that will have only made their first purchase by April 30, 1995, the period during which they may make their second purchase will expire on December 31, 1995.

Decision No. 10961-(95/41), adopted
April 19, 1995

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

3. ADMINISTRATIVE AND CAPITAL BUDGETS, FINANCIAL YEAR 1996

The Executive Directors, meeting in restricted session, considered the Managing Director's statement on the Administrative and Capital Budgets for Financial Year (FY) 1996 (EBAP/95/24, 3/31/95). They also had before them a nationality distribution list of the staff (EBAP/95/26, 4/4/95) and a paper on staff recruitment and retention experience in calendar year (CY) 1994 (EBAP/95/23, 3/28/95).

The Executive Directors then turned to the proposed decisions, which they approved.

The decisions were:

1. Appropriations for administrative expenses for Financial Year 1996 are approved in the total amount of $475,145,000. This amount will apply to the various categories of expense as follows:

I.	Personnel Expenses	
	A. Salaries	$ 210,665,000
	B. Other Personnel Expenses	132,860,000
		343,525,000
II.	Travel Expenses	
	C. Business Travel	42,180,000
	D. Other Travel	26,195,000
		68,375,000
III.	Other Administrative Expenses	
	E. Communications	10,625,000
	F. Building Occupancy	41,525,000
	G. Books and Printing	7,860,000
	H. Supplies and Equipment	8,175,000
	I. Data Processing	17,300,000
	J. Miscellaneous	11,950,000
		97,435,000
	Total	509,335,000
IV.	Reimbursements	-34,190,000
	Total Budget	$475,145,000

2. Commitments may be made for each numbered category I-III up to the amount indicated above. Any commitment going beyond the total approved for each category will be submitted to the Executive Board for approval.

3. The staffing of the Fund as set forth in Table 7 of this paper is approved. The ceilings for total authorized regular staff (2,201.0) and for the total authorized staff (2,690.0) shall not be exceeded without prior approval by the Executive Board.

Adopted April 19, 1995

Capital Budget for Projects Beginning in Financial Year 1996

1. Appropriations for new capital projects beginning in Financial Year 1996 as described in Appendix III are approved in the total amount of $13,400,000. This amount will apply to the various categories as follows:

I.	Building Facilities	$ 5,615,000
II.	Work Practice Improvements	535,000
III.	Computer Equipment	7,250,000
	Total Capital Budget	$13,400,000

2. Commitments may be made for capital building facilities up to $5,615,000, work practice improvements up to $535,000, and computer equipment up to $7,250,000. Any commitment going beyond these amounts will be submitted to the Executive Board for approval.

Adopted April 19, 1995

Assessment Under Article XX, Section 4, Financial Year 1995

Pursuant to Article XVI, Section 2, and Article XX, Section 4, of the Articles of Agreement, and Rule T-2 of the Fund's Rules and Regulations, it is decided that:

(i) The General Department shall be reimbursed for the expenses of conducting the business of the SDR Department for the period from May 1, 1994 to April 30, 1995, and

(ii) An assessment shall be levied on all participants in the SDR Department. The special drawing rights holdings accounts of participants shall be debited on April 30, 1995 with an amount equal to 0.0196 percent of their net cumulative allocations of special drawing rights. The total assessment shall be paid into the General Department.

Adopted April 19, 1995

Structural Adjustment Facility Within Special Disbursement Account, and Enhanced Structural Adjustment Facility Trust - Reimbursement of General Resources Account, Financial Year 1995

Pursuant to Paragraph 10 of Decision No. 8238-(86/56) SAF, adopted March 26, 1986, as amended, and Paragraph 3 of Decision No. 8760-(87/176), adopted December 18, 1987, as amended, it is decided that the General Resources Account shall be reimbursed the equivalent of SDR 22,500,000 for the expenses of administering the Facility and the Trust for the period May 1, 1994 to April 30, 1995, and the reimbursement shall be made at the close of the financial year.

Adopted April 19, 1995

4. INCOME POSITION - NET INCOME TARGET FOR FINANCIAL YEAR 1996, AND RATE OF CHARGE ON USE OF FUND RESOURCES

1. The target amount of net income for Financial Year 1996 shall be 5 percent of the Fund's reserves at the beginning of the financial year.

2. Effective May 1, 1995, the proportion of the rate of charge referred to in Rule I-6(4) to the SDR interest rate under Rule T-1 shall be 102.5 percent.

3. Any net income for Financial Year 1996 in excess of the target amount of net income of 5 percent of the Fund's reserves at the beginning of that financial year shall be used to reduce retroactively the proportion of the rate of charge to the SDR interest rate for Financial Year 1996. If net income for Financial Year 1996 is below the target amount for that year, the net income target for Financial Year 1997 shall be increased by the equivalent of that shortfall.

Decision 10962-(94/41), adopted
April 19, 1995

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/40 (4/14/95) and EBM/95/41 (4/19/95).

5. AZERBAIJAN REPUBLIC - REPRESENTATIVE RATE FOR MANAT

The Fund finds, after consultation with the authorities of the Azerbaijan Republic, that the representative rate under Rule O-2(b)(i) for the manat against the U.S. dollar is the official exchange rate set by the Azerbaijan National Bank according to the auction results of the Baku Interbank Currency Exchange (BICEX). (EBD/95/54, 4/14/95)

Decision No. 10963-(95/41) G/S, adopted
April 18, 1995

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/95/55 (4/17/95) is approved.

APPROVAL: December 20, 1996

REINHARD M. MUNZBERG
Secretary