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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/57

10:00 a.m., June 24, 1994

Contents

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
M.-A. Autheman	M. Sirat
	D. Desruelle, Temporary
J. Bergo	E. Srejber
	J. Dorrington
H. Fukui	T. Kanada, Temporary
	R. Kannan, Temporary
	K.-T. Hetrakul
	W. C. Keller, Temporary
	A. Calderón
	E. Kouprianova, Temporary
	B. M. Lvin, Temporary
	J. Hamilius, Temporary
	J. Jonáš, Temporary
	V. Rigász, Temporary
	R. D. Bessone Basto, Temporary
K. Lissakers	B. S. Newman
R. Marino	G. Torres
A. Mirakhor	H. Golriz, Temporary
	S. Rouai, Temporary
	B. S. Dlamini
	J. O. Aderibigbe, Temporary
G. A. Posthumus	
	J.-C. Obame, Temporary
	E. Wagenhoefer
	G. M. Blome, Temporary
	C. F. Pillath, Temporary
A. S. Shaalan	Y. Y. Mohammed
	T. K. Gaspard, Temporary
	J. Jamnik, Temporary
	R. Rainford, Temporary
	N. L. Laframboise, Temporary
E. L. Waterman	A. M. Tetangco, Jr.
	H. Petana, Temporary
Zhang M.	Wei B.
	Yang X., Temporary
	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present
IBRD: C. Soriano, Advisor to Executive Director; R. Lacey, Latin America and Caribbean Regional Office; J. Salop, Africa Regional Office; H. Shishido, East Asia and Pacific Regional Office. African Department: G. E. Gondwe, Deputy Director; R. K. Basanti, C. Brachet, D. G. Cowen, T. Ehrbeck, M. T. Hadjimichael, M. Nowak. European II Department: M. Shadman-Valavi. Legal Department: D. E. Siegel, F. M. Zeidan. Monetary and Exchange Affairs Department: D. E. Duenas. Policy Development and Review Department: H. W. Brendenkamp, R. A. Jayatissa, M. A. Pinon-Farah, C. Puckahtikom, J. P. Pujol, J. F. van Houten. Research Department: S. Shirai. Secretary's Department: C. Clarke, A. Mountford. Southeast Asia and Pacific Department: L. M. Koenig, Deputy Director; K. A. Al-Eyd, J. H. Felman, C. Parasuk, M. R. Stone. Treasurer's Department: H. Flinch, S. T. Lurie. Western Hemisphere Department: S. T. Beza, Counsellor and Director; C. M. Loser, Deputy Director; A. S. Bevilaqua, J.-P. Amselle, A. Caetano-Filho, L. A. Cardemil, L. A. V. Catao, M. Da Costa, J. E. Di Tata, L. H. Duran-Downing, O. Gronlie, B. C. Stuart, M. Terrones. Office of the Managing Director: G. R. Saunders, Personal Assistant; C. S. Lee. Advisors to Executive Directors: M. A. Ahmed, A. Chang Fong, G. Y. Glazkov, T. Oya, J. R. Suárez, J. W. van der Kaaij. Assistants to Executive Directors: S. E. Al-Huseini, S. Arifin, J. M. Burdiel, A. G. Cathcart, G. Z. El-Masry, J. C. Estrella, S. S. Farid, R. Ferrillo, L. Fontaine, C. Gaseltine, C. Imashev, G. J. Matthews, S. C. McDougall, J. A. K. Munthali, J. Pesola, R. K. W. Powell, N. Prasad, M. W. Ryan, D. Saha, G. A. Sánchez, A. Sighvatsson, L. Tase, R. von Kleist, S. Vori, Wang X., J. B. Wire.

1. PHILIPPINES - 1994 ARTICLE IV CONSULTATION; AND EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1994 Article IV consultation with the Philippines and the Philippines' request for a three-year arrangement under the extended Fund facility in an amount equivalent to SDR 474.5 million (EBS/94/117, 6/3/94; Cor. 1, 6/3/94; Cor. 2, 6/23/94; Sup. 1, 6/22/94; and Sup. 1, Cor. 1, 6/22/94). They also had before them a background paper on recent economic developments in the Philippines (SM/94/149, 6/14/94).

Mr. Tetangco made the following statement:

The period since 1986 has proved very challenging to the Philippines, which was faced with the need for economic reform to provide the basis for growth while having to cope with the task of building political consensus in a newly restored democracy. The challenges were further complicated by the series of natural calamities, particularly in the early 1990s, that imposed additional burdens on the economy. The authorities nevertheless persevered with reforms that would strengthen public finances, open the economy to foreign investment, and reduce the role of government in the economy through privatization, while seeking ways to reduce the financial burden of a huge external debt. The present Government, elected in 1992, has continued the effort with even firmer resolve to create the right environment to promote faster and sustainable economic growth.

The policy framework has increasingly reflected commitment to macroeconomic stability and economic liberalization. As noted in the staff report, among the important recent measures are the restructuring of the central bank or Bangko Sentral ng Pilipinas to grant it greater independence and bolster its financial position to improve the conduct of monetary policy and supervision of the financial system; foreign exchange liberalization, which lifted virtually all current account restrictions and relaxed capital account regulations; liberalization of foreign investment rules, which removed all restrictions on the extent of foreign ownership in export enterprises and generally allowed 100 percent foreign equity in domestic market enterprises; continuing trade and tariff reform; and privatization of state-owned companies.

The economy has started to show unmistakable signs of recovery. From sluggish output growth in 1992, activity gathered pace in the second half of 1993, resulting in an increase of 2.4 percent in real GNP for the year as a whole. The rise in GNP, brought about mainly by strong export growth and increased investment, was helped by the alleviation of the electric power supply problem that earlier had affected consumer and producer confidence. Annual GNP growth accelerated to 4.8 percent in the first quarter of 1994, with exports and investment continuing their remarkable performance.

The improvement in macroeconomic conditions under the last stand-by arrangement has been sustained with the continuation of generally prudent financial policies. In 1993 inflation averaged 7.6 percent compared with 18.7 percent two years earlier. While some price pressures have been felt in recent months, the average for the first five months of 1994 remained at the single-digit level.

In the external sector, the current account deficit rose 5.9 percent in 1993 from 1.8 percent in the previous year despite the strong performance of exports as imports rose significantly. While the rise in imports was broadly based, about 35 percent of the increase during the year was due to generally nonrecurring imports of power-generating equipment and planes for the fleet modernization program of the now privately controlled Philippine Airlines. As expected, the current account deficit declined as a percent of GNP in the first few months of 1994, to 4.7 percent in the first quarter, with the continued increase in exports of goods and services, and a slowdown in import growth.

Notwithstanding wider current account deficits, the balance of payments has not been put under any severe stress, as substantial voluntary capital flows poured into the economy with the renewal of confidence and the restoration of capital market access. Reflecting these developments, the Bangko Sentral ng Pilipinas (BSP), has been able to build up official reserves. However, the surge in capital inflows, following the same phenomena elsewhere, is generating its own set of complications including the orderly management of the exchange rate and the implementation of the monetary program. The present monetary program attempts to grapple with this problem through a modest adjustment mechanism. It would, nevertheless, be prudent to monitor developments in this area closely in any future review to validate the assumptions underlying current program design.

The medium-term strategy, characterized by the staff as very ambitious, is focused on raising the level of domestic savings to finance an increasing level of investment while reducing the current account deficit. Strengthening of the fiscal position will underpin the targeted increase of 6 percentage points in gross national savings to reach 23.9 percent of GNP by 1997--a level seen in the early 1980s.

Higher public sector savings will be brought about through measures to both enhance revenue and restrain expenditure. The recently approved expansion in the coverage of the value-added tax and the introduction of a 3 percent minimum import duty constitute concrete steps to improve revenue performance. The authorities are aware that further improvements to the tax system envisaged in the work program of the Task Force on Tax and Tariff Reform are essential to achieving further fiscal consolidation. The authorities also recognize that restraint will need to be maintained on current expenditure to allow an increase in capital spending to improve infrastructure consistent with the requirements of growth.

Proceeds from privatization will provide the Government with some breathing space in the budget by helping to reduce debt-service obligations. While the authorities intend to continue to use part of the proceeds to alleviate underinvestment in the public sector, the bulk of the receipts will be used to reduce the Government's domestic debt. In the past, privatization receipts mainly financed expenditures.

Consistent with fiscal consolidation is the strengthening of the operations of government corporations to minimize the need for budgetary support. Thus, steps have been taken to depoliticize energy pricing and allow prices to adjust to market developments. The National Power Corporation (NPC) has adopted a formula for adjusting electric power rates based on exchange rate movements as well as changes in purchased power cost and world fuel prices. In the petroleum sector, a similar flexible pricing mechanism is being considered. Automaticity in oil pricing will be reinforced by the limitation of the balance in the Oil Price Stabilization Fund (OPSF) to between zero and P2 billion.

The strategy also calls for further measures on the structural side to open the economy, including in the areas of foreign investment and trade to enhance efficiency and competitiveness. The recently approved law liberalizing the entry and scope of operations of foreign banks in the Philippines marks the end of over four decades of prohibition of entry by new foreign banks. The law is designed to encourage the participation of leading financial institutions while promoting an environment that levels the playing field for both foreign and domestic banks. The ongoing trade reform will also be continued in line with the country's international commitments, particularly under the World Trade Organization (WTO) agreement and with multilateral institutions.

To foster orderly implementation of the reform measures, the authorities are committed to implementing financial policies consistent with stable macroeconomic conditions.

My authorities attach the highest importance to an economic program supported by the Fund. It is regarded as providing a credible framework for guiding policy as well as reinforcing international confidence in the economy. As further liberalization is pursued, the support of the international community will be essential. The Government will meet with the Consultative Group next month to discuss future donor assistance and with the Paris Club about possible rescheduling of payments to cover modest financing gaps. While an increase in reserve cover--adjusted for gold-backed and security-backed borrowings--to three months of imports is assumed in the program, my authorities would favor a higher level that can provide a greater degree of comfort as they push ahead with the reform effort. The program has taken some time to finalize because my authorities have exerted painstaking efforts to build a stable political consensus behind it. Those efforts have started to pay off in terms of difficult policy actions, especially those in the fiscal area that have acquired the necessary congressional approval. It is not an exaggeration to state that the present program probably enjoys the widest consensus in recent experience in our dealings with the Fund. On this basis, we are confident that this program will be fully implemented and attain its objectives.

Extending his remarks, Mr. Tetangco said that he wished to confirm that the positive macroeconomic developments reported in the supplementary paper had continued over the period January 1994-May 1994. The National Government had posted a higher than programmed surplus, as both revenue and expenditure performance had been better than projected. In addition, net international reserves had continued to be somewhat higher than programmed for the month. The authorities had continued to take measures to bring down base money to within the programmed level. A P 5 billion floating rate note issue had been scheduled for the previous day, and further appropriate steps were expected to be taken in the coming days.

Mr. Jonáš made the following statement:

The staff has provided an informative report on the current prospects of the Philippine economy, and on the problems and distortions remaining to be addressed during the program period. I have found it useful to review the history of the persistent problems that have caused the economy to record such an unsatisfactory growth performance in recent years. Despite significant progress with macroeconomic stabilization, and in some areas of structural reform, many obstacles remain to fill the agenda of the new program.

Indeed, the task ahead is enormous. It still includes addressing myriad structural distortions and market rigidities, as well as improving and increasing investments in both the private and public sectors. Fiscal policies must be enlisted to help maintain macroeconomic balance at the same time that public finance operations are undergoing a major overhaul. And monetary and exchange rate policies must ward off the inflationary side effects of the capital inflows attracted by the country's improving economic prospects.

Let me comment on the principles that should guide the authorities and on the steps they should take to ensure that the goals stated in their memorandum will be achieved.

At the macroeconomic level, the authorities hope to achieve the highly desirable combination of higher growth and lower inflation. Although these two goals tend to be mutually supportive in the longer term, in the short term they may present some difficult trade-offs. In view of the disappointing growth performance of recent years and the urgency of improving the conditions of the poor, the authorities are understandably impatient to see economic growth strengthen quickly. Nonetheless, easing monetary conditions and pushing down interest rates at any cost is not an optimal approach at this time. During 1993 monetary aggregates grew at an alarming pace, and the authorities must remember that even if the initial response should be an increase in output, the longer-term response would mostly take the form of an increase in prices. The authorities should therefore reverse the recent easing by retightening monetary conditions in this and the coming years to keep monetary expansion in line with inflation targets.

Although I recommend a strong tightening of monetary policy, I do not I think fiscal policy should be as stringent, and I agree with the idea of back-loading the fiscal adjustment. This easier fiscal policy does not find its justification in the need to stimulate aggregate demand--not the most important role of fiscal policy--but in the need to redress the insufficient supply of genuine public goods, from adequate infrastructure to appropriate assistance for the poor. This is especially appropriate now, as once the planned tax reforms have been implemented, it should become possible to reduce the fiscal deficits with less damage to the provision of these public goods. At this stage it is therefore preferable to focus on restructuring public expenditures and improving the revenue performance, instead of immediately cutting the relatively small deficit. This back-loaded approach must, nonetheless, be pursued with caution in view of high interest payments and the relatively large size of the public debt. To reduce the sizable interest payments, it would also be reasonable to earmark the proceeds from privatization for partial retirement of public debt.

The external sector also exerts constraints on the conduct of fiscal policy because a sustainable current account balance cannot be achieved without adequate fiscal and monetary discipline. As for exchange rate policy, the authorities are well advised by the staff to refrain from fixing the exchange rate at any particular level. Improved efficiency and increased investment opportunities can be expected to attract sizable capital inflows. If these inflows enhance the productivity of domestic producers, matching appreciations of the currency will not necessarily harm export performance. In any case, the economy must have foreign investment if it is to achieve investment and growth levels comparable to those of its neighbors.

All the measures planned by the authorities in the areas of liberalization and privatization are good, but there are still some regulations that make little economic sense, and here the authorities should proceed more boldly. Take, for example, the unusual requirement that only foreign banks that have attained a certain size in their domestic economies or the world economy can operate in the Philippines. What happens if a bank that qualifies to operate in the Philippines later falls back to sixth or seventh place among the banks of its home country? Is its license then withdrawn? And if not, what is the real purpose of this policy?

Even though the Philippines has become a long-term user of Fund resources, I agree with the staff that economic and political conditions have become more conducive to significant progress with economic reform, and I therefore can support the authorities' request.

Mr. Shaalan made the following statement:

Despite the successes in macroeconomic stabilization and structural reform over the past decade, major impediments to growth still remain in the Philippines. These include weak domestic savings resulting from a small and protected financial sector, widespread import restrictions, particularly in the agricultural sector, and the poor state of public finances. Furthermore, excess demand fueled by an early easing of monetary policy and increased confidence in the economy has allowed inflation to accelerate rapidly, and the current account deficit to widen significantly.

We support the authorities' request for an extended arrangement, which aims at reducing these impediments, thereby creating an environment conducive to growth. Three issues, however, deserve particular attention, namely market liberalization, public sector finances, and the financial policy mix.

We welcome the program's emphasis on market liberalization, particularly in the financial and agricultural sectors. We commend the authorities for recently relaxing market access in the small and protected financial sector. Increasing the level of financial intermediation and intensifying competition by allowing foreign banks to enter the market should help mobilize domestic savings and reduce reliance on foreign financing. We also welcome the programmed replacement of quantitative restrictions in the agricultural sector by tariffs. These restrictions have been contributing to high prices for agricultural produce, notably corn, which in turn have reduced competitiveness in the poultry and food processing industry. However, we note with concern that rice will remain regulated, and encourage the authorities to liberalize the importation of rice, and to lower the tariffs on agricultural products in general as soon as feasible.

We are concerned about the state of public sector finances. While at first glance the fiscal deficit might seem low, once nonrecurrent revenue from privatization is excluded, the underlying consolidated public sector deficit is much larger and has been growing since 1990. This is but one of the weaknesses in the fiscal situation; the other equally important aspect is the structure of public finances.

The staff rightly highlights the constrained structure of public expenditure. Because over one third of revenue is earmarked to service public debt and another one fourth to pay public sector wages, the fiscal authorities are left with few discretionary funds to use for other purposes. We therefore, support the restructuring of public expenditures aimed at reducing recurrent outlays and mobilizing public sector savings to generate resources to accelerate needed infrastructural investments, while reducing the deficit. In this connection, we welcome the planned reduction of the overall public sector wage bill, by reducing overstaffing in the civil service, while also increasing real wages for public employees to levels comparable with the private sector. However, one wonders how realistic these intentions are. As regards the transfer of additional functions and personnel to local government units, we are concerned that the devolution process may result in a mere shift of the fiscal deficit from the national to the local level. Staff comments on these issues would be appreciated.

On the revenue side, we welcome the authorities' intention to enhance tax revenue by broadening the tax base, reducing exemptions and improving tax administration. We are, nevertheless, concerned that these measures will take time to produce tangible results, and as in the past, revenue increases will quickly be followed by increases in recurrent expenditures.

The mix of monetary and fiscal policies, as proposed by the staff, gives me some cause for concern. To control demand, the staff proposes that in the initial stage of the program emphasis be placed on tightening monetary policy, with fiscal policy playing an insignificant role. If I understand it correctly, the scenario over the program period is expected to unfold in the following manner:

It is assumed that confidence in the program's credibility and, in particular, the relatively high level of real interest rates associated with tight monetary policy will give rise to an acceleration of capital inflows, which may need to be sterilized if the inflation target is to be met. The staff believes that as the program progresses, fiscal policy will assume a more important role in the adjustment process, and as inflation declined, interest rates would start to trend down, encouraging private investment. The latter will be aided, inter alia, by the Government's restructuring of expenditures, creating room for needed infrastructure outlays. In this process savings are targeted to increase by some 6 percent, mostly owing to the public sector. Private savings are not expected to show much change.

In addition to the tightness of the scenario outlined above, my concern regarding the policy mix arises from the fact that tight monetary policy, which is probably needed in the absence of up-front fiscal measures, could well give rise to unacceptably high interest costs in the budget. This, in addition to planned reduction in tariff rates, could make budgetary consolidation more difficult. Moreover, given the optimistic objectives of the program, policy slippages would adversely affect the scenario. This is important, as the staff scenario postulates a sharp increase in public sector savings, but most of the measures to produce this result are far from firm, both on revenue enhancement and on expenditure containment. In this connection, could the staff inform us of any contingency measures in the event that the budgetary objectives do not materialize.

The first full paragraph of the staff appraisal on is worded so cautiously that I have failed to understand it, particularly where it says:

> "...should this attract sizable capital inflows, the authorities plan to respond with a pragmatic mix of intervention and appreciation. In striking an appropriate balance between the two responses, the staff believes that it will be important to avoid resisting persistent market pressures. As inflation is reduced to ASEAN norms, interest rates should fall and the exchange rate should stabilize at a competitive level."

Could the staff explain what is meant by "a pragmatic mix of intervention and appreciation," while avoiding "persistent market pressures?"

Mr. Jamnik made the following statement:

It is encouraging to see the staff present to the Executive Board an almost fully funded program. The fact that the country in question is the Philippines is even more gratifying. We trust that the requested three-year arrangement under the extended facility will represent an exit program for the country. My comments today are in no way intended to detract from the achievements realized to date; they are simply intended to introduce some notes of caution.

In spite of a number of commendable policy decisions taken by the authorities over the past years, the Philippines still faces a number of problems in its pursuit of a sustained growth path similar to that attained by its ASEAN neighbors. Clearly, the authorities will have to remain vigilant on all fronts.

The arrangement calls for accelerating real growth over the program period, reaching 6 percent in 1997. This rate of economic growth will require a substantial increase in both savings rates and the efficiency of investment. Attention needs to be paid to reducing the structural impediments to doing business, which hinder the country's productivity. Although progress has been made in this respect--the planned reforms of the banking sector is a notable example--we would urge the authorities to take more ambitious steps in this direction.

Fiscal consolidation has not been a strong point of Philippine economic policy and, indeed, the current program may not be ambitious enough in this respect. We were, however, encouraged by the results outlined in the background paper.

We agree with the staff that the emphasis should be placed on fiscal measures that will have a durable effect on the budget deficit. It is certainly wise to avoid recourse to "palliative and distortionary measures." Nevertheless, it might be possible to accelerate the implementation of some measures that have already been planned. For example, the authorities might be able to proceed more rapidly with the elimination of certain subsidies or broadening the base of the value-added tax.

A reduction in the budget deficit, already in 1994, would allow the authorities more latitude in their fight against excess demand pressures provoking the current acceleration in inflation. Indeed, to put most of the weight of inflation control on monetary policy will mean restrictive monetary conditions that the authorities might have difficulty maintaining.

In the external sector, the staff is projecting a current account deficit of 2.5 percent of GDP in 1997, down from 5.9 percent in 1993. This is probably welcome, but as we have indicated on other occasions, a higher current account deficit is not necessarily a problem, particularly if it is associated with a recovery in private investment. To the extent that the current account deficit reflects private decisions with respect to savings and investment, rather than excessively large government deficits, there is less reason for concern. Indeed, such an evolution in the external accounts can reflect an improvement in the economic prospects of a country giving rise to capital inflows.

In view of the potential cost pressures that could result from the large expected capital inflows, it is essential that the authorities take measures to reduce their own requirements, so as not to drive interest rates higher than in needed to offset inflationary pressures. Our fear here is that rather than attaining a low-inflation environment, the economy could end up being less price competitive internationally if there is an increase in the real effective exchange rate.

I would note that the Philippines has rescheduled its external debt to official creditors four times under the auspices of the Paris Club. According to the balance of payments tables in the staff report, the Philippines can expect small financing gaps throughout 1994 and 1995, and it is expected that external financing needs will be fully met by 1996. Yet, in spite of strong, renewed access to international capital markets, the authorities have requested a further rescheduling with the Paris Club. We do not feel that this is necessary, and in fact, it could have a negative effect on the country's creditworthiness and the cost of capital. Comments by the staff or Mr. Tetangco regarding the rationale behind the rescheduling request would be greatly appreciated.

I will leave it to other speakers to comment more extensively on issues related to structural reform. Suffice it to say that we welcome progress in this area. We are particularly satisfied to learn that the authorities intend to deregulate the petroleum sector. The current system is excessively politicized and gives rise to all sorts of distortions in the economy, as well as being an excessive budgetary charge. We also welcome the policy of progressive opening to foreign investors.

We support the proposed decisions.

Mr. Sirat made the following statement:

I agree with the three main objectives of the program, namely, to put public finances on a sound footing, to enhance competition in the financial sector, and to further deregulate the economy.

My main question relates to the implementation of this general strategy. This question is twofold: the possibility of rapidly achieving a higher sustainable growth, and the possible negative impact of capital account developments on the growth strategy.

I implicitly understand from the report that growth would stem mainly from an export-led strategy, as apparently occurred in the last few months. Indeed, it is far from certain that the relatively modest reduction in the government balance would suffice to impulse a strong domestic response of the private sector.

As mentioned in the review of the Fund's arrangements to be discussed next week (EBS/94/104 and Cor. 1, 5/19/94; EBS/91/84, 4/15/94; and Sup. 1, 6/8/94), growth is often slow to respond to adjustment measures. This raises the question of the sustainability of the reform process. In any case, the authorities should certainly not try to artificially accelerate growth through an excessively lax policy mix: recent figures are mixed, and I share Mr. Jonáš's concern in this regard.

This growth-oriented strategy will face two difficulties. The financial sector might react slowly to an increase in the demand for credit from the private sector. The opening of the relatively oligopolistic domestic market to foreign banks, in a context of a low level of intermediation, is certainly welcome, but its effect might well be only of a medium-term nature, particularly regarding the financing of small and medium-sized enterprises, which could suffer in the short term from continued high spreads. In this context, and given the welcome restructuring of the Central Bank, the authorities might consider a rapid reduction in reserve requirements so as to limit the indirect taxation of intermediation. Such a measure would have to be kept consistent with the overall monetary target.

Some segment of exports, such as garments or sugar, might suffer in the short run from a change in bilateral quota arrangements. In this context, the choice of an appropriate exchange rate policy will be crucial.

I understand that the authorities do not intend to implement any kind of targeting, either of the nominal rate or of the real rate. But I would appreciate some elaboration on issue of export competitiveness of exports in the face of past loss of competitiveness vis-à-vis ASEAN competitors, as exemplified in Chart 2, and of an inflation target for 1994 above the level prevailing in the main competitors. Besides, past months have shown that it is possible that the country may be faced with an exchange rate appreciation through the development of short-term inflows. Indeed, there could be some contradiction between this export-led strategy, which would require--at the minimum--a nonappreciation of the real exchange rate, and the possibility of large capital inflows, leading to high interest rates and/or an exchange rate appreciation.

Some capital inflows are clearly needed, as the balance of payments is still constrained. Even if the program is based on an export-led growth, the trade balance would remain in sizable deficit.

The situation is so tight in the short term that the authorities are considering the possibility of asking for a Paris Club rescheduling. My authorities are certainly ready, in principle, to consider such an action. But it is not totally clear that a new rescheduling would be in the best interest of the Philippine authorities, as it might hamper the credibility of their reform process for relatively small rescheduled amounts, in a context of a recent dramatic increase in international reserves. I agree with Mr. Jamnik on this point.

However, it is difficult to attain just the right amount of capital inflows. As past months have shown, there is a clear possibility of a surge in capital inflows in conjunction with relatively high interest rates. The management of these capital account developments will be extremely difficult with the existing policy mix.

I understand from the report that the authorities are considering allowing the exchange rate to appreciate: such a course of action might well reinforce the problems of the export-led strategy. It is possible that at some point, the authorities would wish to rely on sterilization, pushing interest rates upward with a negative effect on private investment. Such a situation might be more manageable with a tighter fiscal policy, allowing for a fiscal surplus. I understand that this is a concern shared by Mr. Shaalan.

In any event, and as a strict minimum, the proposed fiscal package, which I understand was politically difficult to decide upon, should be closely monitored by the authorities to avoid any slippages. Any acceleration of the implementation of measures contemplated on the revenue side would certainly be welcome.

On the expenditure side, the core investment program and the marked increase in expenditures aimed at poverty alleviation should be protected. Besides their direct, positive impact on both growth and social indicators, they might well have a positive indirect effect on the credibility of the adjustment process. The authorities should be ready to implement strong action on the limitation of recurrent outlays and public enterprise deficits, notably regarding the NPC. In particular, savings on interest payments might be less than anticipated in view of possible developments on the U.S. dollar interest rate and on domestic rates because of the sterilization of inflows.

On the revenue side, the authorities will rely more on administrative and structural measures to enhance the efficiency of the present system than on the creation of new taxes or increases in tax rates. In view of past difficulties in fully implementing existing taxes, particularly in a context of a widespread tax evasion, the proposed approach might well encompass some risks. However, the results achieved in the first few months of this year are reassuring. This being said, it is regrettable that some distortionary taxes, such as taxes on financial intermediation, will not be removed more quickly.

The period ahead will be a difficult one: the authorities will have to effectively implement a strong and credible fiscal package; monetary developments will need close monitoring; and a further opening up of the economy will be needed. In any case, it will be crucial to avoid sending to the private operators a signal of fragility or instability of the reform process, as such a signal would, markedly hamper growth as it had in past years. I support the proposed arrangement.

Mr. Fukui made the following statement:

Immediately after the successful completion of the stand-by arrangement for the Philippines on March 31, 1993, the Philippine authorities embarked on discussions on an extended arrangement to ensure sustainable growth over the medium term. However, the negotiations sometimes reached deadlock because of difficulties, particularly with the Congress, about the prospects for economic reform in the Philippines.

Against this background, the staff visited Manila in January to try to convince the authorities and leaders of Congress. It was gratifying, therefore, that the authorities, in response to the staff's advice, began to intensify their efforts at economic reform, and that the required prior actions for the extended arrangement were implemented. For example, in May 1994, the prohibition against foreign bank entry was repealed and new legislation became effective that extended the coverage of the value-added tax to most exempt sectors. I warmly commend the staff's efforts as well as the authorities' response.

In light of the current situation in the Philippines, where the macroeconomic indicators are generally favorable, it is obvious that what is most required are bold actions in the structural area rather than concentrating on improving macro-economic performance. Therefore, I support the authorities' decision to enter into an extended arrangement that includes various ambitious structural reform measures.

We understand that the Philippines has a long history of not taking the necessary actions, owing to strong and persistent political resistance; for example, the prohibition against foreign bank entry that has been in place since 1948 had never been amended. In this context, prior actions that had been taken recently indicate remarkable progress. Under the extended arrangement, many ambitious measures are also envisaged, such as the adoption of a new price formula for electricity by the NPC. I believe that if all of the measures are implemented as scheduled, the credibility of the Philippines will be enhanced and the attainment of sustainable higher growth, which is already prevailing in other ASEAN countries, will be within reach.

As I support the thrust of the extended arrangement, I will make only a few comments on specific policy issues.

The good performance this year on the macroeconomic side evidenced the authorities' capability in economic management. Two developments, however, are cause for concerns.

First, the growth rate in the first quarter of 1994 is 4.8 percent, which seems somewhat on the high side in terms of program projections. I would suggest that the authorities should lose no time tightening their financial policy at the slightest sign of a surge in inflation or a deterioration of the balance of payments.

Second, I suspect that the staff might be too optimistic about future capital inflows. I would urge the authorities to bear in mind the great uncertainty in this respect, particularly in the context of the rise in interest rates worldwide and to be ready to take the necessary measures to keep attracting capital inflows.

On the structural side, I believe that the measures in the program are important steps in the right direction. However, as the staff rightly points out, many details of the authorities' strategy still remain to be filled in. They have to decide how to reduce the size of the civil service and to identify which functions can be taken over by local government units. As they decide these matters, the authorities are expected to be subject to enormous political pressure. I hope they will be resolute in resisting such pressures and proceed with the implementation of the program, paying due attention to the adverse effect on the Philippines' credibility if the measures are watered down.

As to financial assistance to the Philippines, while it appears that the size of the financing gap in the coming years will be small because the prospects for capital inflow are good, I still believe that the donor community should continue to provide sufficient financial assistance, as drastic economic reform is still at an early stage and prospects for the external position are subject to great uncertainty, and it would be effective to back up a strong program with corresponding strong support in order to strengthen the momentum for ambitious reform.

On behalf of my authorities, I am pleased to report to the Board, on an informal and confidential basis, that the Export-Import Bank of Japan will provide a loan for balance of payments support in parallel with the extended arrangement, amounting to $400 million. My authorities intend to formally announce this decision at the consultative group meeting scheduled for July 21 and 22. With these remarks, I support the proposed decision.

Ms. Lissakers made the following statement:

Among the many attributes of this well-written staff report is the effort to cast the development of the Philippine economy in a regional context, consistent with the Government's laudable aspirations of catching up with its high-growth neighbors. As the staff points out, the key to achieving comparably high economic growth rates--macroeconomic stability, competitiveness, and external viability--will be the success of efforts to increase domestic savings and investment, particularly in the public sector. The extended arrangement provides an appropriate framework for these objectives, and we can support both the proposed decision and the overall thrust of the Philippine reform effort. However, there are a number of policy areas where a more aggressive approach is perhaps warranted.

With regard to the pace of fiscal adjustment in particular, protracted fiscal problems have adversely affected growth in the Philippines in a number of ways in the past. It is therefore critically important that the Philippines move ahead to reduce the public sector deficit over the course of the program. In this connection, the up-front measures to increase revenues, including implementation of the broadened value-added tax, are particularly welcome elements of the 1994 fiscal program.

However, the staff appraisal conveys a sense of unease with the fact that the bulk of the fiscal adjustment is being postponed until 1995 and 1996. The recent approval by the Congress of legislation needed for the extended arrangement may indicate that fiscal measures will have a smooth path and move ahead on the timetable that has been laid out. The fact that central government revenues are ahead of program projection in 1994 is another encouraging sign. Still, given past problems in developing a national consensus for reform measures needed to shore up the budget, we share the staff's unease.

In this context, and with regard to the fiscal/monetary mix, there will be little alternative to forging ahead with the medium-term fiscal program. Interest rates are already high, and capital inflows are expected to remain strong. Monetary policy cannot be counted upon to pick up any slack, or the investment and export-led growth objectives of the program could be jeopardized. Several speakers have commented on the potential dilemma that could be faced. We have seen other insistances where countries became dependent on short-term capital inflows, and kept interest rates at a level that became an impediment to domestic growth and investment. I think that developing countries in a position to attract or currently attracting, large capital inflows need to be aware of this potential trap, and take offsetting measures on the structural and fiscal side to make sure that they do not fall into it.

Outside the central budget, it is disappointing that, taken collectively, the government corporations will continue to impose a sizable fiscal burden. Indeed, when privatization receipts are excluded, there is no improvement in the collective deficit of these companies in 1994, as their operating deficit remains unchanged. The NPC remains at the center of the problem, which underscores the need to stick firmly with the automatic electricity pricing system introduced in April, and to move forward quickly with plans to narrow the role of the NPC. Similarly, without restructuring, and where possible, full and early privatization of the other monitored corporations, as well as the nonmonitored corporations already stated for privatization, should move ahead in order to achieve the necessary increase in public saving.

As to other aspects of the Government's role in the economy, we cannot endorse the continued existence of the OPSF. As the report notes, at best, the OPSF gives rise to a number of distortions; at worst, it could again burden the Government's finances, as it did as recently as 1993. The fact that the OPSF is not running a deficit at present makes this a propitious time to abandon the scheme altogether. Overall, deregulation of oil pricing and imports ought to proceed on a faster timetable than envisioned in the program, present legislation notwithstanding, as this has been a source of major economic distortions in the past.

As the staff indicates, distortions arising from the closed, inefficient nature of the financial markets and the high costs of financial intermediation have long been a major stumbling block to a stronger economy. The closed nature of the credit system goes hand in hand with the oligopolistic structure of many private businesses in the Philippines in the past. Opening the financial sector will be key to changing the structure of the private sector and making it competitive and more efficient, in order to reach the goal of bringing the Philippines up to the international competitiveness, growth, and prosperity level of its neighbors. As such, the reform and restructuring of the Central Bank last year and the passage by the Congress of the long-awaited foreign bank liberalization package last month are important milestones. However, it was somewhat disappointing that the Philippines did not go further by removing altogether the restrictions on entry by foreign bank branches. Even with this package, the Philippine market may still be significantly harder to enter than others in the region, and as Mr. Jonáš mentioned, the rationale for some provisions in the final legislation are hard to understand. Mr. Sirat mentioned that opening the financial sector to foreign competition may only yield returns in the medium term. The more open it is, perhaps the more rapidly the benefits of increased competition will be visible.

As to other deregulation issues of particular concern, the final table of the background paper shows the progress that has been made in reducing quantitative restrictions, which have been a particular problem in the trade regime. Nevertheless, many quantitative restrictions remain, and the imposition of quantitative restrictions on a host of agricultural products last year was a step backward. The commitment to eliminating agricultural quantitative restrictions by March 1995 and most other quantitative restrictions in phases by early 1997, while welcome, should be accelerated.

Similarly, the Philippines needs to move to an import system that lowers and standardizes import costs and improves transparency. In this connection, we are pleased that the distortionary "home consumption value" (HCV) system will be abandoned early in 1995, but we do not see the Brussels definition of value as a fully satisfactory solution either. A specific target date should be set for adoption of the WTO valuation definition in its place.

Poverty alleviation must be a firm objective as the Philippines moves toward high-growth status. The staff report and the background paper points out that real per capita income remains at the 1978 level, that one half the population lives below the poverty line and one fifth fall below the subsistence level, and that income distribution remains extremely skewed. This grim assessment underscores the need for sustained growth and the need to pare back the welter of regulations and obstacles that stand in the way of income and employment-generating activities in the private sector.

This extended arrangement marks a renewed commitment to advancing the process of reform in the Philippines. Assiduous implementation is important in any program; in the case of the Philippines, it is particularly important that it quickly establish a good track record under the extended arrangement. The staff's report on the recent visit to Manila is encouraging, and as Mr. Tetangco notes, domestic conditions for program implementation now look auspicious. We look forward to three years of solid progress under the extended arrangement that will boost the Philippines' economic performance closer to that of its peers in the region, and obviate the need for continued financial support from the Fund and other donors.

Mrs. Hetrakul made the following statement:

I would like to commend the Philippine authorities for the strong implementation of far-reaching structural reforms to address the country's systemic economic problems. As a result, the economy is now more open and more competitive, with an expanding export base. Economic growth continues to accelerate, albeit at a low level. The rapid expansion in exports has resulted in a declining debt-service ratio. A new democratic Government is in place. Overall, a strong foundation has been built for a more comprehensive adjustment over the medium term. I am reassured that such an adjustment enjoys a stronger political consensus than ever before, and the Government has clearly signaled its firm commitment to completing the daunting tasks ahead. As Mr. Tetangco underlines in his statement, there is general optimism that greater economic prosperity is just down the road.

The major challenge to the Philippines is the elevation of economic growth to its potential long-term path without sacrificing macroeconomic stability. This level of growth has been achieved before--during the 1970s--and is comparable to the level recorded by neighboring ASEAN countries. This is not an easy task. The crucial key to its success lies in the accumulation of savings to finance the desired level of investment. If this is possible, then the ambitious medium-term growth objective can be met. Efforts to bring down inflation to a low of 4 percent in three years in an environment of economic expansion will be a challenging task. It calls for faster progress in lifting structural constraints on the supply side to supplement appropriate demand management policy. The reform agenda is an impressive one, but I believe that its medium-term targets are achievable in light of the political support and the fresh commitment of the Philippine authorities.

The role of monetary policy will be central to the successful implementation of the medium-term plan. The monetary expansion in 1993 has greatly contributed to the country's macroeconomic imbalance and must be reversed to lock in the recent gains in inflation. The primary responsibility will be on a prudent monetary policy, perhaps with the exchange rate and credit as nominal anchors. However, monetary policy alone will not be enough. It needs the support of a stable fiscal balance and adequate progress in structural adjustment in the financial and real sectors. I therefore welcome the recent restructuring of the Central Bank, which has allowed the independent execution of monetary policy. Notwithstanding the shifting of the Central Bank's financial loss to the National Government, the restructuring will go a long way in rebuilding the credibility of the Central Bank and restoring confidence in the financial system as a whole. Moreover, savings opportunity will be widened and deepened by the authorities' actions to allow the entry of new foreign banks and their intention to reduce taxation on financial services. In view of increasing competition, I urge the authorities to strengthen banking supervision in order to promote the development of a sound domestic banking system.

The role of public finance in stimulating economic development is somewhat constrained by the liberal fiscal policy of the past. A substantial part of fiscal revenue is required to service the large debt position. However, like Mr. Jonáš, I do not think that further reduction in the fiscal deficit is a high priority at this time, although I would not like to see the deficit widen further. More urgent talk is the enhancement of the revenue position and better prioritization of government expenditure.

The medium-term target to raise fiscal revenue by 4 percent to 21 percent of GNP by 1996 appears reasonable. The introduction of a new value-added tax law and the creation of a Task Force on Tax and Tariff Reform again underline the authorities' strong commitment to fiscal reforms. I would like to encourage the authorities to take concrete steps to improve tax administration and enforce tax compliance.

On the expenditure side, the huge interest payments will continue to be burdensome for some time. The target of containing noninterest current expenditure to about 10 percent of GNP throughout the program is commendable. However, public investment remains low, with a considerable need for the development of infrastructure. Therefore, there is some urgency to reallocating government expenditure from operating to capital spending. In addition, while civil service salary adjustments may be unavoidable, the Government should be resolute in restraining any wage increase to a moderate level.

The authorities are to be commended for their actions on structural reforms. These good efforts must continue in the area of oil pricing policy, trade liberalization, and privatization. On the latter, it is encouraging to see the reduction in the deficits of the 14 monitored nonfinancial corporations, but it is unfortunate that there is no change in the large deficit of the NPC. The weak financial position of the corporation reflects, among other things, a weak power supply and distribution network. I am pleased to note that the reform of energy pricing policy will allow automatic tariff adjustment to compensate for an increase in fuel prices. Further adjustments should include the containment of costs and the improvement of productivity. The downsizing of the corporation's activities, which is being developed with the assistance of the World Bank and U.S.AID, would help improve the efficiency of its operation.

In closing, I strongly believe that the Philippines' medium-term program deserves international support. The Fund's assistance would serve as a catalytic role in securing much needed assistance from international donors and in attracting foreign investors. With these remarks, I support the proposed decision.

Mr. Dorrington made the following statement:

I agree with many of the detailed points made by earlier speakers, and I will concentrate most of my remarks on program design issues.

Considering the past record of prolonged use of Fund resources, and the expectation that this is an exit arrangement, I would have hoped to see the program specified much less ambiguously and with significantly more front-loaded measures than that proposed today.

The authorities seem to be more committed than in the past to the program, and I fully understand the political difficulties in making up-front commitments to fiscal and structural changes. But getting policy measures through the legislature is a difficult hurdle in many countries, and while the difficulties are understandable, they are of little comfort to the Fund, especially in areas of the Philippines' past record of slippages. Moreover, weak programs only undermine the credibility of the Fund's seal of approval with the outside world. Having said that, there are some good structural measures planned, and the restructuring of the Central Bank is being conducted in a sensible and pragmatic way.

While it is obviously too late for the Board to have any impact on the initial program design, this places extra importance on the guidance we give to the staff now about the performance required to bring reviews of this program back to the Board. In this context, I could not understand why the staff did not insist on structural performance criteria, or even on benchmarks, instead of providing a list of key structural measures linked to the reviews. It is most important that, in practice, the staff treat these as if they were performance criteria.

More front-loading of fiscal adjustment would also have brought greater confidence effects, thereby potentially enhancing private external financial flows. Infrastructure investment, while necessary, should not precede finding budget savings elsewhere. Timely implementation of the promised measures is therefore absolutely critical. According to the memorandum on economic and financial policies, specific proposals are now due to be made this month on the minimum business tax. I wonder whether this has been done yet. Another area for important early action is the pricing measures required to reduce the deficit at the National Power Corporation. Indeed, reducing that deficit is clearly crucial.

While a Fund seal of approval will be helpful to the Philippines, in the short run at least, the balance of payments need for this program is, to put it mildly, debatable. The financing gap calculations should be seen as illustrative rather than definitive; namely, a slower reserves buildup could have been programmed, as is envisaged in the alternative scenarios. I also wondered whether it is a coincidence that purchases almost exactly match scheduled repurchases of the earlier drawing under the compensatory and contingency financing facility; are we in effect rescheduling?

Therefore, it is more important than usual to be clear that by approving this program, the Board is not implicitly endorsing the Philippines' request for a rescheduling of its Paris Club debt. I agree with Mr. Jamnik and Mr. Sirat that it seems quite likely a request would simply damage the Philippines' international creditworthiness, and so reduce the flow of private external finance. Of course, this is ultimately a matter for the Paris Club to discuss with the authorities, but I want to emphasize that there should be no suggestion from the Fund that the program is dependent on a rescheduling.

I also hope that the authorities will seriously consider not making purchases--or at least not making all the purchases--under this arrangement. This would be another sign of strength, which might be more than compensated for by stronger private flows of finance.

The program is not strong, particularly in the first year, and in view of the debatable balance of payments need, and the relatively high outstanding access, it is absolutely correct that access under this program is relatively low. One could argue it should be even lower.

In conclusion, I can support the proposed decisions, albeit with serious reservations.

Mrs. Wagenhoefer made the following statement:

According to an article in The Financial Times, the Philippines has implemented not less than 22 Fund-supported programs in the last 30 years. The country can thus rightly be labeled as an extreme case of prolonged use of Fund resources, with little sign of improvement over time. We are therefore extremely grateful that--to use the staff's words--"in marked contrast to previous programs, the financing assurances for the program supported by this arrangement are strong." It also seems that the political situation in the Philippines has stabilized substantially, and that the more favorable outlook of the world economy--especially for the Philippines' major trading partners--will also help to make this program more successful than the almost two dozen the country has had so far.

As we agree with the general thrust of the staff report and of the proposed program, I will only comment on three issues, namely, public finances, external trade, and external debt.

We agree with the staff that the poor state of public finances is probably the most critical impediment threatening the Philippines' economic success. Although we generally agree with the notion of substantially raising real wages in the public sector while at the same time reducing the size of the civil service, we wonder whether these measures should be executed within a very short time of each other. It would probably be better to first reduce the number of public employees and only after some time increase their wages. With the authorities rather poor track record on such matters in mind, such a sequencing would add to the credibility of the reform program and at the same time, strengthen public finances. As the program aims at increasing tax yields, and as a range of tax and fee increases have recently been adopted that will probably show up in the price statistics, excessive wage increases in the public sector could set a bad example for the rest of the economy, further driving up inflation rates. In view of consistent price pressures, the dampening effect of these factual tax increases on consumer spending would be helpful, especially in light of additional demand pressures from large capital inflows. Most of the complications, as Mr. Tetangco calls the effects of capital inflows, could be effectively countered by adequate reductions of the public deficit.

As regards external trade, we commend the authorities for the bold steps they have undertaken so far to liberalize trade restrictions. We nevertheless support the staff's view that the level of protection on the newly tariffed products should be reduced at a faster rate than foreseen under the Uruguay Round agreement. This is especially true for the oil sector, in which government involvement entails significant financial risks. A further reduction in import tariffs and the abolition of remaining nontariff barriers might also help to further stabilize the domestic political scene, especially in the Senate. The Philippines should also strive to broaden its base of export customers, as the United States, Japan, and the European Union today account for more than 70 percent of all its exports. Considering the extremely low base, there should be considerable scope for expanding regional trade ties, especially as the Philippines seems to have successfully started a transition from predominantly agricultural exports to manufactured goods exports.

It is, indeed, a heavy debt burden that a previous regime has left the Philippine people to carry, but recent progress has been encouraging, the Philippines' return to capital markets and the high influx of foreign capital are two encouraging signs of a normalization of the Philippines' relations with external creditors. Against this background, and in view of the small financing gap, it is difficult to understand why the authorities want to reach another rescheduling agreement with the Paris Club. As other speakers have outlined, this might harm the country's future prospects on capital markets more than it will benefit the country. I would go one step further and question the need for using the financial resources of the Fund, and whether a Fund-monitored program would not have been the better choice for the Philippines.

If the authorities strictly adhere to the reform program and quickly fill in the missing details, the country definitely has the potential to catch up with its more successful neighbors in the region and to be released from the "credit drip" of the international community. The first steps have been taken; in the face of the long experience of failed programs, however, we would like to caution against premature optimism. We strongly hope that this program will enable the Philippines to finally stand on its own feet and to no longer be dependent on financial support from the Fund. With these comments, I can support the proposed extended arrangement.

Mr. Keller made the following statement:

We welcome the staff's relentless efforts to establish this program. We recognize that the proposed extended arrangement is destined to help the Philippine authorities boost international and domestic confidence in their reform efforts. Considering the buoyant regional environment, it is indeed timely and appropriate for them to take advantage of the country's undeniable growth potential. There is a window of opportunity now, as the encouraging recent economic results confirm. We can support the proposed arrangement and we hope that it will enable the Philippines to pursue a self-sustained adjustment path in the future.

Political stability is a major condition for renewed confidence in the Philippines. However, it is still unclear to what extent the militant and often violent opposition has been subdued, or whether it has simply gone into hiding. Recent inflows of foreign capital seem to suggest the former. Still, the staff appears overenthusiastic when appraising the "improved consensus in favor of appropriate economic policies," as well as praising "several recent bold actions." I will elaborate on these two aspects while broadly agreeing with Mr. Dorrington's comments.

On the aspect of improved political consensus, Fund experience with earlier programs in the Philippines and the negotiations for this program should suggest some modesty in this respect. Economic decision-making in the Philippines remains highly politicized and, in turn, political-economic factors determine much of economic and reform performance. The crux of the implementation of policy measures has always been to resist often opportunistic and contrary political pressure, which has hardly subsided. The Government's rollback of petroleum prices and the tax increases in February 1994 are, in this respect, clear cases in point.

If the envisaged back-loading of the fiscal adjustment effort could be justified on technical grounds--and I will revert to this question later--it is even more difficult for political reasons. Considering the 1995 elections for the House of Representatives and the Senate, the timely implementation of fiscal policy measures under the program faces an additional major risk, in the form of renewed populism, which could find a rich ground in widespread popular dissatisfaction and poverty. Good governance remains an issue for all segments of government, as well as the intricate links between the public sector and the oligarchy. We see little evidence in the program of the required depolitization of the Government's role in the economy. We have the impression that reform actions will continue to depend on a political approach.

On the aspect of recent actions, the staff is right to insist on the "remaining impediments" to growth, most of which are precisely rooted in excessive politization. The issues are clearly identified, but the policy strategy to achieve the objectives is much less clear. In the words of the staff, "the problems are long-standing, and have resisted numerous past attempts to resolve them." Bolder actions, to be implemented without delay, are required. This leads me to the following questions concerning the policy strategy envisaged in the staff report.

First, on fiscal consolidation, should fiscal adjustment be back-loaded, when "the public finances are found in a poor state, contributing to macroeconomic imbalances and uneven policy implementation," and when fiscal consolidations are, according to the strategy, the first step of the reform program? I share Mr. Shaalan's concerns in this respect.

Second, on financial sector reform, is the gradual opening of the banking sector for foreign banks and lower taxation sufficient to change entrenched oligopolistic habits and install true competition, not only in the financial sector but also in the entire economy, as well as to bring about the ambitious objectives for domestic savings and investment?

Third, on macroeconomic stabilization, the temptation to achieve short-term growth through monetary expansion has to be resisted in view of the rampant inflation pressures. This leads to the question: How independent is the rehabilitated Central Bank?

And on economic liberalization, what measures are planned to further improve the technical and financial performance of the NPC, particularly in light of the high costs experienced with the new power plants built by the private sector?

The still very patchy policy strategy needs refinement. We would urge the authorities to fill in the crucial details of their policy measures consistent with the program and to resist pressures to dilute its thrust. We would encourage the staff to review these in a broader context and assess the implementation of the program--including the political determinants--in a candid way. As the reforms will probably have to go beyond what is programmed at present, they should be sped up, so as not to lose any precious time if the Philippines is to eventually close ranks with the ASEAN neighbors in terms of economic growth and if the problem of widespread and abject poverty is to be effectively addressed. With these comments, we wish the Philippine authorities well in their challenging endeavor.

The staff representative from the Southeast Asia and Pacific Department observed that Directors had generally focused on program design and on the appropriate mix of fiscal and monetary policies. In that regard, he recalled that a year earlier, the Executive Board had given clear instructions to the staff regarding the nature of the program that the Philippines should pursue. The main elements of its advice were that any future program should address the deep-seated structural issues that were the main cause of the uneven performance, the cycles of boom-and-bust, and the associated pressures on the economy. With that in mind, the staff and the authorities had taken some time to address those issues.

The main objective of the program was to reduce the public sector deficit significantly, the staff representative remarked. A more rapid reduction of the deficit in 1994 than was envisaged in the program, however, would have been difficult because of the structure of government expenditures and the limited discretion available to the authorities. Of the two possibilities for achieving a further reduction, namely, increasing revenues or cutting expenditure, the authorities were working on revenue measures, some of which would require some time to reach their full potential. As to expenditure cuts, they could only be achieved by reducing the relatively small allocations to infrastructure and development spending, and perhaps social expenditures. That would not be advisable, especially in view of the program's overriding objective of ensuring that the economy began to recover and reached a sustainable level of growth over a reasonable period of time.

That did not imply that there would be no fiscal adjustment in 1994, the staff representative continued. The authorities had already taken bold steps--in terms of expanding the value-added tax--and a minimum business tax was being considered by the Task Force on Tax and Tariff Reform, which was being advised by a Fund technical assistance mission. The new tax was to be presented to Congress during the session commencing in July, and the authorities would be working closely with the leadership of the Congress to ensure its passage in 1994.

Important work was also under way, with the assistance of the World Bank, on a review of the structure of government expenditure, the staff representative commented. That far-reaching exercise included not only an evaluation of expenditures but also of the management of government resources. A reduction of the civil service was a key element of the program in that regard, and it should be noted that the reorganized Central Bank had already taken steps to substantially reduce the size of its work force.

Greater progress in the fiscal area was foreseen for 1995-96 and beyond, the staff representative stated. That had put some pressure on monetary policy in the initial phase of the program and, in view of the current situation in the Philippines, had inevitably led to some capital inflows. Those developments should perhaps be seen in terms of their longer-term benefits. For exporters, a more competitive exchange rate would be desirable, but it was equally important to have a stable macroeconomic environment, low interest rates, and a more stable exchange rate.

Experience in the Philippines showed that any quick attempts to lower interest rates through monetary expansion would lead to other pressures, as had happened the previous fall, the staff representative observed. With that in mind, the authorities had decided to resort to some sterilization. In the meantime, the program allowed for some expansion of base money in the event that net international reserves exceeded the program such levels. The amount of expansion was limited, however, because it was recognized that it was only through a reduction in inflation and, therefore, a reduction inflationary expectations, as well as a lowering of the real interest rates that the Philippine economy could hope to become competitive. Any appreciation of the exchange rate was likely to be short term, but it would be beneficial to the extent that it forced exporters to be more competitive. In the current phase of development, that would be welcome.

The authorities had pressed for more liberal access of foreign banks to the Philippine market, the staff representative observed. Although the compromise banking law had some restrictive features, in general, only foreign bank branches were subject to limitations. Foreign banks could fact, acquire up to a 60 percent majority share in commercial banks and could in incorporate as domestic banks in the Philippines. Although the banking system was still overprotected and intermediation costs remained high, impeding financial intermediation, it was hoped that the restructuring of the Central Bank and the reduction of reserve requirements, together with the competition being introduced through the entry of foreign banks, would contribute to a revitalization of the financial sector.

On the sequencing of public sector reform and wage increases, while the simultaneous restructuring and rationalization of the civil service would have been consistent with the Government's policy of reducing the size and role of the public sector and releasing resources to the private sector, the authorities faced the difficult problem of a substantial erosion of wages in real terms over the past few years and the consequent loss of some key personnel, especially in the NPC, where qualified engineers and technicians were leaving in large numbers, the staff representative explained. The proposed program of civil service reform and restructuring, and in particular, the reorganization of the executive branch, was, however, expected to yield the hoped-for result, namely, a smaller size, but with a level of wage compensation that was consistent with and comparable to the private sector.

On fiscal adjustment, the staff agreed with Directors that there was little room for slippage in implementing policies, the staff representative from the Southeast Asia and Pacific Department remarked. As had been stated in the staff appraisal, the back-loading of certain measures was a source of some risk for the implementation of the program.

Another staff representative from the Southeast Asia and Pacific Department, commenting on whether the staff projections on capital inflows were optimistic in light of interest rate developments in other countries, observed that, in fact, the projections of Eurobond issues were extremely conservative: it was assumed that over the medium term, only $300 million would be issued annually, compared to about $1 billion in 1994. Moveover, while some short-term capital inflows in 1994 reflected the impact of monetary tightening, over the medium term, such inflows would reflect the reintegration of the Philippines into world capital markets. In fact, several processes were under way. Exporters were bringing borrowed money into the country, while, at the same time, foreigners were investing significant amounts in Philippine domestic paper, particularly government treasury bills. That equilibrium process could be expected to force Philippine real interest rates closer into line with international interest rates. The program was conservative in that, while it assumed that the flows would continue at approximately the current levels, the budget projections did not assume any significant decline in real interest rates.

Another segment of capital inflows was foreign investment, and there, the signs were encouraging, the staff representative continued. Investment registrations for the first five months of 1994 were 16 percent higher than total registrations for all of 1993. The increase was attributable to several factors, particularly the elimination of power shortages and a general feeling that a period of significant growth lay ahead for the Philippines. Moreover, as a result of the continued liberalization and opening up of the economy, foreign investors were expected to be involved in establishing new businesses and in the new banks that were allowed under the new banking law.

As to the home consumption value reform, imports in the Philippines were overvalued for customs purposes because valuation was based on a notional price in the home country of export rather than the actual export price, which was normally considerably lower, the staff representative explained. For many years the authorities had recognized the problem but had not known what to do about, it because a shift toward a declared transaction value, for example, would run into severe verification difficulties, which the customs administration was not well equipped to handle. As an intermediate step, before going to the WTO definition of customs valuation, they had decided to shift to the Brussels definition of value. Although the Brussels system was not perfect, it was the prevailing system in all Asian countries except Japan. The advantage of using that system was that the burden of proof lay with the importer rather than with the customs officer. As experience was gained, the Philippines could shift to the WTO definition, say, within five years.

The staff representative from the Policy Development and Review Department observed that the question regarding the need for a Paris Club rescheduling and the need for Fund financial involvement were related to the question of balance of payments need. The Philippines had recently made great strides in opening up its economy and in liberalizing both the current and the capital account. One consequence was greater exposure to capital flows and greater potential volatility in the level of reserves. The staff did not view the programmed level of reserves over the coming years--at three months of imports--to be particularly high. Indeed, the authorities would have liked it to be higher, especially in light of the exchange crisis a few years earlier in which reserves had dropped to less than six weeks of imports. Fund financing should help to catalyze financing from various sources, including in the context of the forthcoming meeting of the Consultative Group on the Philippines. Together with a rescheduling from the Paris Club, it should also help ease the fears of private investors. Moreover, the balance of payments need, while not large, was modest to fair; consequently, the proposed level of access, at 25 percent of quota, was also modest and well below the annual access of stand-by or extended arrangements over the past ten years. The fact that disbursements were similar in magnitude to repurchases falling due was coincidental; he could assure Mr. Dorrington that no "rescheduling" of resources was intended.

The authorities believed that a Paris Club rescheduling was needed to gain bilateral support for their program, the staff representative explained. Moreover the coverage of the requested rescheduling was limited to those debt service payments not previously rescheduled and to a consolidation period of 18 months. The staff further understood that the requested rescheduling would be an exit rescheduling. The amounts to be rescheduled were thus considerably less than had been requested on any previous occasions and represented less than one third of the reschedulable debt service from Paris Club creditors.

On issues of program design, it was true that none of the structural measures was a performance criteria, the staff representative from the Policy Development and Review Department stated. The staff had taken that course in recognition of the authorities' view that such specification would be counterproductive insofar as it would not be helpful in assuring congressional passage for any of the measures. Consequently, the strategy chosen was to link each review to the passage of certain measures. There was therefore a strong link between the completion of the reviews and particular measures even though they had not been specified as performance criteria.

Mr. Dorrington said that he would be interested to know whether the staff had presented the substantial downside effects of a Paris Club rescheduling to the authorities. He would also like some reassurance that if there was a Paris Club meeting, the staff would not say anything that could be interpreted as indicating that rescheduling was absolutely essential to the program. While he took the point about reserves, the numbers were at the margin.

There could be Fund endorsement of a member's policies without Fund financing, Mr. Dorrington observed. The worst possible scenario for the Philippines would be to agree to a program only to have it go off track. That would be far worse than not having had a program at all. It was absolutely essential that the program be adhered to.

The staff representative from the Policy Development and Review Department stated that the downside of Paris Club rescheduling had been strongly emphasized in the staff's discussions with the authorities. Those arguments had, however, been overtaken by events: the Japanese Government had already signaled that it would provide sizable support for the

Philippine program. Having fully debated the costs and benefits of rescheduling, the staff had gone along with a modest exit request to the Paris Club. In that connection, he could assure Mr. Dorrington that in the course of any Paris Club discussions, the staff would make clear that the program would fall or succeed on the basis of the policy measures being pursued and not because of Paris Club rescheduling.

For the Philippines, the Fund's financial support as well as its endorsement was important at the current stage, the staff representative from the Policy Development and Review Department remarked. In the outer years of the program, if all went well and foreign financing, including private sector financing, came on board strongly, the possibility might exist for forgoing purchases under the arrangement. The Philippines was, however, not there yet.

Mr. Fukui observed that in the absence of Paris Club rescheduling, there would be a financing gap and bilateral aid would be needed to fill the gap. As Japan's bilateral support assumed that any gap would be filled, and to that extent, was related to the Paris Club rescheduling, he would like to see a firm indication by bilateral donors that the financing gap would be filled in the event that there was no rescheduling.

The staff representative from the Southeast Asia and Pacific Department, commenting on the issue of Paris Club rescheduling, said that the authorities believed that a relatively high level of reserves was important for their medium-term strategy because of the liberalization policies they were pursuing, because a high level of reserves would lend confidence to foreign and domestic investors, and because they were in a region where, traditionally, reserve costs were higher than in most other regions. With that in mind, their strategy was to pursue several avenues. One was access to Fund resources, although the amount being requested was, indeed, modest. The other was access to capital markets. There, the staff had cautioned that capital market borrowing should be kept within prudent limits and that it was not without cost; recent floatings by Philippine corporations involved margins of 200 to 300 basis points. The third avenue was bilateral contacts, including with the Export-Import Bank of Japan.

The staff had supported the authorities' request for a rescheduling on the understanding that it would be limited in duration and coverage; namely, limited to the second half of 1994 and 1995 for amounts that had not been previously rescheduled, the staff representative from the Southeast Asia and Pacific Department remarked. It had also stressed that the rescheduling should provide a soft exit for the Philippines from the Paris Club. Any staff comments in Paris Club meetings would be along those lines.

Mr. Sirat asked whether it was correct to say that the financing gap for 1994 was on the order of 1 percent to 2 percent of exports and more than 3 percent of reserves--or within the margin of error. He also wondered whether the staff had elaborated new balance of payments projections for 1994, taking into account the welcome developments on the capital account since the beginning of the year. As to exchange rate policy, did the staff consider that, at its current level, the exchange rate allowed for competitiveness of the economy?

The staff representative from the Southeast Asia and Pacific Department said that the staff had not revised its projections for 1994 because the available data were still preliminary. In any event, even if exports were to increase by 2, 3, or 5 percent, and even if imports were to remain as projected, the addition to reserves would still be modest. Therefore, any positive developments, either in the current account or in the capital account, would not negate the authorities' view that reserves should be augmented. Indeed, the program should provide that any additional balance of payments support in 1994 would go automatically to increasing reserves. Moreover, as the world oil price projections used in the staff's projections for 1994 did not reflect recent price increases, a small shortfall in exports or a small increase in imports arising from higher oil prices could result in an even larger financing gap.

As to the implications of higher oil prices for other sectors of the economy, their impact would not be felt in the OPSF for several months, and by that time it was expected that the flexible pricing policy would have been introduced, so that the higher costs would be passed on immediately to the consumer, the staff representative from the Southeast Asia and Pacific Department stated. For the moment, higher oil prices should not have much impact on the inflation target. Domestic prices were currently based on an average import price of $15 per barrel; the additional impact of an increase of $2 per barrel for the last few months of the year should not have much effect.

Another staff representative from the Southeast Asia and Pacific Department said that if the assumptions underlying the medium-term projections were to change dramatically, the staff would have to review the program and discuss with the authorities the implications of any major changes in price assumptions. In any event, the projections would be updated in the context of the first midterm review. It should also be noted that domestic oil prices were influenced not only by developments in world oil prices but also by movements in the exchange rate of the peso vis-à-vis the U.S. dollar; that, at present, was a mitigating factor.

The staff representative from the Policy Development and Review Department observed that the medium-term projections assumed that there would be no change in the real effective exchange rate over the program period. Also, it was true that the financing gap was within the margin of error with respect to the import assumption. But it was also necessary to look at the assumption regarding medium- and long-term inflows, mostly autonomous inflows. That was a large number, and the gap was also within the margin of error of that estimation. In the staff's view, the possible errors or statistical changes on exports and imports were offset by those on autonomous capital inflows, so that there would still be a financing gap, which was small but not negligible.

Mr. Dorrington recalled that in presenting the case for a Paris Club rescheduling, the staff had noted the spread that the Philippines had to pay on the capital markets. It should be noted that a rescheduling would influence future spreads, which underlined the view of a number of Directors that a Paris Club rescheduling was not in the interest of the Philippines.

Mr. Jamnik asked whether the Consultative Group would be meeting before the Paris Club. The timing was important to creditors, who would like to be reassured that they were filling the residual gap.

The staff representative from the Southeast Asia and Pacific Department replied that the Paris Club meeting was scheduled to precede the Consultative Group meeting.

Mr. Tetangco recalled that the staff had had long discussions with the authorities on a Paris Club rescheduling. Among the authorities themselves there had been different views on how to proceed, but in the end, considering the uncertainty surrounding the external position--particularly owing to the recent increase in oil prices, as well as the volatility of short-term capital inflows, which had been the main source of increasing reserves--the authorities had adopted a strategy that involved borrowing from multilateral and bilateral creditors as well as from the international capital markets--but at prudent levels--and a modest rescheduling with the Paris Club. The level of reserves presented in the staff report was considered by the authorities to be a minimum; a higher level would give them a greater degree of comfort as they pushed ahead with the reform program. That had been part of their plan since they began negotiating a program with the Fund.

Some Directors had indicated that, as the Philippines had regained access to international capital markets, it should not have to request a Paris Club rescheduling, Mr. Tetangco continued. It should be noted in that regard that the recent increase in bond yields had caused some uncertainty among companies in the Philippines about the feasibility of access to international capital markets. In fact, they were currently waiting for a more propitious time to go to the markets. It should also be noted that the amount of rescheduling being requested was significantly smaller than--past reschedulings--about $500 million over one and a half years. As the objective under the program was to achieve external viability, the authorities considered the request as an exit rescheduling with the Paris Club.

On the shift of import valuation from home consumption value, the authorities considered that a transition period using the Brussels definition of value would be prudent in view of the potential adverse impact on revenue collection of shifting directly to the WTO system, Mr. Tetangco explained. That approach allowed for validating import values while avoiding the risk associated with relying on transacted prices alone, which could be influenced by commercial factors rather than the worth of the goods themselves. The authorities also believed that there was a need for customs personnel to become familiar with the new WTO system, which was similar to the Brussels definition. They also considered it desirable to synchronize the adoption of the WTO system with the planned reduction in tariff levels, which would avoid the difficulty of having to administer the new system while there were still several levels of tariff rates.

The Government had established an action plan toward full deregulation of the oil sector by the beginning of 1997, Mr. Tetangco stated. During the transition, both the forward cover arrangement for oil companies and the OPSF would be phased out through the adoption of an automatic pricing mechanism, which would allow the public to become accustomed to frequent price adjustments before prices were fully liberalized. The timing of the deregulation program was contained in the law creating the department of energy, and considering the sensitivity of oil pricing, as well as the heavy agenda of reform, including new revenue measures, the authorities considered that it would be extremely unwise to reopen the issue. It should be emphasized that the planned automatic pricing mechanism would seek to maintain a positive balance in the OPSF up to P 2 billion, thereby eliminating the need for budgetary support.

Significant progress had been made in trade reform, including the plan to submit the WTO agreement for ratification by October, Mr. Tetangco observed. That would allow the lifting of quantitative restrictions on agriculture products. In the case of rice, the retention of such restrictions was a second-best solution, but the reality was that the farming sector could be a strong political force to contend with. That approach was consistent with the GATT agreement, particularly Section II of Article IV, which allowed developing countries to maintain quantitative restrictions on a primary staple product--in the case of the Philippines, rice. There was still a need to improve the competitiveness of Philippine farmers in the face of continuing huge agricultural subsidies in some foreign countries. In that connection, the package of support measures that were being provided included the upgrading of technology and infrastructure, and the deregulation of support sectors, particularly transportation.

Mr. Jiménez de Lucio made the following statement:

> Recent macroeconomic developments in the Philippines are encouraging. The consolidated public sector deficit has been reduced significantly since 1990 and is now at a relatively low level. Not surprisingly, inflation has also been declining and has already reached single-digit levels. In addition, output growth resumed last year and is showing increasing strength in 1994. We commend the authorities on the progress to date with the implementation of their stabilization and liberalization program. Ensuring high, sustainable rates of growth should now become the main objective of economic policy. Thus, we share the staff's assessment that the removal of the remaining distortions constraining growth is the biggest challenge currently facing the authorities.

Despite the relatively low fiscal deficit, the public finances remain weak. In the past, an important share of revenues has been derived from distortionary taxes, which need to be eliminated, and from privatization receipts, which will cease in the near future. Thus, higher revenues are crucial for the completion of the already initiated process of tax reform. We welcome the projected restructuring of expenditure--and the reduction of the government debt/GNP ratio--as conducive to higher efficiency and lower uncertainty, reversing the crowding out of private investment. Strong emphasis should be placed on improving the administration of the tax system. The back-loaded nature of the fiscal adjustment places a high premium on the announcement of a detailed timetable for undertaking the next steps in fiscal reform, and meeting it. In this regard, it is reassuring that the majority of the fiscal measures already taken have enjoyed congressional approval.

Until the economy resumes a steady growth path driven by higher savings and investment, tight monetary policies should be pursued. The risks associated with excessive increases in the money supply are illustrated by last year's nominal shock, which led to an acceleration of inflation during the second half of 1993. We agree with the staff and the authorities that attempts to peg the exchange rate in response to continuing capital inflows would be futile, and that only a limited intervention should be pursued. A policy of continued purchases of foreign exchange and subsequent sterilization would only increase interest outlays in the government budget, with no substantial benefits.

Current domestic macroeconomic policies and strong capital inflows should exert upward pressure on the exchange rate. Hence, in the medium term, a trade deficit is likely to persist, notwithstanding the curbing of aggregate demand. In this context, export growth will have to come from productivity gains generated by continued implementation of structural reforms. External viability will also depend on the ability to continue attracting capital inflows, preferably nonspeculative and long-term, that is, less vulnerable to changes in international capital market conditions. These inflows, which can contribute to economic growth, will in turn be partly a function of the pace and depth of structural reforms.

Briefly stated, the future health of the Philippine economy depends to a considerable extent on the program of structural reform. Although substantial progress has already been made, more remains to be done. We welcome the proposed program of reforms. Nevertheless, we should stress the importance of implementing all of the proposed reforms, in order to deal with the low savings and investment rates, which are the key impediments to growth. In this regard, we fully share the emphasis given in the staff appraisal to the importance of eliminating the distortions that have kept financial costs well above returns on investment, while pushing downward the returns on savings. At the same time, the fiscal reform, aimed at reducing the government borrowing requirements and eliminating distortionary taxes, should make room for private investment. However, this effect is unlikely to be significant unless the financial reforms, particularly the liberalization of the banking sector and the reduction of reserve requirements, are fully implemented.

We support the proposed decisions.

Mr. Al-Tuwaijri made the following statement:

It is heartening to note that the perseverance of the Philippine authorities in their adjustment efforts seems to have created the critical mass of reform needed to activate the economy. Indeed, the higher than expected growth in the first quarter of 1994 is encouraging. However, sustaining and invigorating this growth over the medium term will require continued vigilance by the authorities. To this end, I endorse the well-designed program before us as it should go a long way in addressing the remaining gaps in the reform effort.

The emphasis in the program on financial sector reform is particularly welcome. Reducing the level of taxation on financial intermediation and allowing foreign banks to enter the market would enhance competition, reduce the high spread between deposit and lending rates, and encourage savings. Moreover, it would allow for the needed tightening in monetary policy without putting undue pressure on lending rates.

Achievement of the monetary targets would also be facilitated by the planned reduction in the fiscal deficit. In this regard, focusing on revenue mobilization by expanding the tax base and by simplifying the tax codes to enhance efficiency and facilitate collections is appropriate.

On the expenditure side, it is encouraging to note the authorities' emphasis on rationalizing current spending over the medium term by substantially reducing the overall size of the civil service and by addressing the problem of transfers to the local governments. The rationalization of current spending would allow for the savings needed to finance the major infrastructure investments required to sustain growth, without undermining the tight fiscal stance. Here, I agree with the staff that it is important for the authorities to specify at an early date concrete steps to affect such a reduction in expenditures. I also urge the authorities to monitor the fiscal situation closely and to implement additional measures, if needed, to stem any slippage.

This is particularly relevant in view of the back-loading of the fiscal measures.

The realization of the fiscal targets would also require an accelerated pace of public enterprise sector reform, especially as regards the NPC. The recent sharp increase in the deficit of this sector adds urgency to the matter. In this connection, the authorities' privatization efforts are a step in the right direction. Privatization would increase efficiency and could also generate resources to reduce the large public debt, which has been a major drag on the economy.

Implementation of measures along these lines, coupled with further liberalization in the areas of foreign investment and trade should enhance confidence, encourage investments, and facilitate sustainable, noninflationary growth. In this connection, I am greatly encouraged by Mr. Tetangco's statement that this program enjoys wide support and that he is confident it will be fully implemented.

Ms. Kouprianova made the following statement:

The Philippines provide a good example of Fund involvement, as the previous arrangement was successfully completed. Although important progress has been made in structural reform and economic stabilization under the previous arrangement and the latest data are encouraging, there are still a number of areas where improvement is needed. The acceleration of inflation, together with the deterioration of the balance of payments in the past year caused by the pressure of excess demand, set the challenges in achieving medium-term goals. We are confident that the proposed extended arrangement will pave the way to sustainable growth and macroeconomic stabilization of the economy. As other speakers have provided a comprehensive analysis of the economic situation of the Philippines, and this chair agrees in general with the thrust of the staff's appraisal and supports the proposed decision, I would like to limit my intervention to four brief comments on the main areas of policy strategy.

First, regarding the area of fiscal consolidation, the widening of the consolidated public sector deficit by 0.7 percent of GDP in 1993, following a significant improvement in the fiscal position in 1990-92, provides a reason for concern. The authorities' efforts to reduce this deficit are justified. On the revenue side, we especially support the mostly conservative measures that the authorities are currently taking, namely, the augmentation of revenues not by the introduction of new taxes or an increase in tax rates, but by raising yields from existing taxes. On the expenditure side, the Government's intention to comprehensively restructure expenditures is welcome. The goal of limiting noninterest current expenditures to 10 percent of GNP also seems attainable. One area of concern is that of transfers to local government units, and we support the steps that the authorities intend to take to limit this amount, and so reduce the budget deficit.

Second, concerning financial sector reform, the problems that the authorities face in the structural area are at the core of the overall improvement process. Such an important step as the easing of restrictions on foreign banks' entry will encourage competition and stimulate domestic and foreign investment, thus playing an important role in the structural transformation of the economy. As for the restructuring of the Central Bank, although this reform has already strengthened the Central Bank's role in conducting monetary policy, the Government has certainly paid a price for this reform, with an increase in interest payments by 2.1 percent of GDP in 1994. Would the staff please further elaborate on the role and the consequences of this reform?

Third, regarding macroeconomic stabilization, the performance of the economy has been mixed, and there were several slippages. Our first concern is in regard to monetary performance. We certainly support tightening monetary policy, as the decrease in inflation and in broad money growth will improve the overall macroeconomic situation. The second concern is that although the Philippines has made substantial progress in addressing its debt problem, there is a further need for maintaining prudent debt management policies to sharply reduce the external debt, which amounted to 62.9 percent of GDP in 1993. This is crucial for a country like the Philippines. The increase in the domestic debt to almost 46 percent of GDP in 1993 is also a point of concern. We welcome the steps that the authorities are currently taking and will take to address this important issue.

Fourth, regarding economic liberalization, impressive progress in this area has been achieved, but there is certainly room for further efforts. We welcome the authorities' intention to liberalize the oil sector and trade, and to introduce the legal framework for stimulating foreign investment, together with further measures to implement the ambitious privatization program.

In conclusion, we are confident that the Philippines will meet the main macroeconomic objectives of the program. This chair supports the proposed decision, and asks Mr. Tetangco to convey to his authorities our commendation for their efforts on the road to assure macroeconomic stabilization and sustainable growth.

Mr. Aderibigbe made the following statement:

The recent strengthening of policy measures by the Philippine authorities to overcome major problems that have characterized the economy since the 1980s is noteworthy. Current efforts will, no doubt, build on the progress made since the 1980s in stabilizing and liberalizing the economy, while shifting the industrial strategy to a more outward-oriented stance in which the role of the private sector is enhanced.

Although these achievements translated into improved external sector performance in 1991 and 1992, and the restoration of the country's access to international capital markets, real output growth--at 0.4 percent in 1991 and 1.0 percent in 1992--was substantially lower than the potential for the economy and the average growth rate for the region. Against this background, the current program of adjustment, framed in a medium-term context, seeks to restore the economy to a high and sustainable growth path, contain inflation at the average rate for the region, and ensure external viability over the medium term.

We welcome the measures outlined in the authorities' memorandum of economic and financial policies as well as the prior action taken toward the achievement of those goals. Broadly, financial and structural policies have been designed to substantially raise the savings and investment ratios from their current low levels, and to eliminate financial imbalances and all structural impediments to economic efficiency. Toward this end, fiscal and monetary policies in 1994 focus on the containment of excessive liquidity growth, which characterized 1993 and influenced the resurgence of high inflation, intensified pressures on the peso, and furthered the deterioration of the external current account.

We welcome the authorities' fiscal consolidation strategy, which emphasizes improved tax efforts and expenditure rationalization and restructuring away from noninterest current outlays to investment spending on infrastructural facilities. However, as the staff observed, we are concerned that the back-loading of the deficit reduction could, during the initial year of the program, constrain efforts to reduce the stock of government debt and bring down the real rate of interest, which is needed to stimulate private sector productive activities. It is important for the authorities to watch government outlays on wages, allocations to local government units, and financial support for monitored nonfinancial corporations, particularly the NPC, if the quantitative fiscal targets specified under the program for 1994 are to be met.

A restrictive monetary policy is critical to achieving the inflation objective. Besides, the essence of financial sector reform in achieving enhanced efficiency in the mobilization and allocation of domestic resources, as well as in improving the effectiveness of the Central Bank in monetary management, should be recognized. In this regard, we welcome the recent restructuring of the Central Bank and urge the authorities to expedite action to further liberalize the banking sector, which remains highly protected. This would help create a more competitive banking environment and encourage the introduction of various additional financial instruments for mobilizing savings. The authorities indicate the option of allowing the peso appreciate to deal with the adverse effect of volatile capital inflows. I wonder whether the likely adverse effect on the export sector has been evaluated.

On the structural front, we commend the authorities for the progress made so far, particularly in the area of privatization, and encourage them to sustain the momentum, and accelerate the financial restructuring of monitored public enterprises. Adherence to the programmed removal of quantitative import restrictions is also advised.

The external sector outlook appears promising. We encourage the authorities to enhance the Philippines' competitiveness in the region through the adaption of appropriate wage and exchange rate policies. We hope that donor assistance will be sustained at the current level to support the program.

We support the proposed decision.

Mr. Wei made the following statement:

We join previous speakers in commending the authorities for their efforts to stabilize and restructure the economy. We are pleased to note that the economy has been further liberalized and shows an upswing after two years of sluggishness. However, many structural problems remain to be addressed.

The authorities' medium-term objectives have been clearly defined; namely, increasing the rate of growth and reducing the rate of inflation in relation to its ASEAN neighbors, while achieving balance of payments viability. In order to achieve these goals, the authorities have adopted a policy strategy of fiscal consolidation, financial sector reform, and economic liberalization. We are in general agreement with the staff appraisal; thus, I would like to comment briefly on some selected issues.

Increasing public savings should be the core of fiscal consolidation. We note that the authorities' program envisages a substantial restructuring of expenditures, including the containment of discretionary current expenditure and the reduction of the overall size of the civil service. We believe that streamlining the public sector will not only help contain expenditure, but also could increase the efficiency of investment. We believe that continuing the pursuit of prudent debt management policies is another important aspect of fiscal consolidation, while fully approving the authorities' debt management policy.

The authorities' policy of opening the financial sector to foreign competition is most welcome, and financial sector reform should be carried out with a view to strengthening the Central Bank's supervisory role as well as its role in formulating monetary policy. We note that the problem of central bank deficits has finally been addressed with the support of the World Bank. It is important for monetary policy to be in line with the objective of price stability. We agree with the staff that monetary policy--which was highly expansionary in 1993--should be tightened. In this respect, we support the authorities' cautious approach to conducting its monetary policy as outlined by Mr. Tetangco.

The authorities' liberalization program is comprehensive and includes import liberalization, the reduction of restrictions on foreign investment, and the completion of a privatization program. Foreign direct investment is relatively low in the Philippines in comparison with its neighboring countries. As the economy becomes increasingly more sound and stability improves, the liberalization will contribute to improving the investment environment.

In general, we believe that the authorities' medium-term program is appropriate. Realizing the objectives requires determination and firm policy actions. The successful implementation of the program will lay a good foundation for the Philippine economy and enable it to grow on a sustainable basis. We support the proposed decision.

Mr. Rouai made the following statement:

We welcome the authorities' commitment to tackling the remaining impediments to growth in the context of a medium-term program of macroeconomic stabilization and structural reform under an extended arrangement.

Fiscal consolidation is clearly the yardstick by which the success of the program is to be assessed, particularly in view of the back-loaded nature of the fiscal adjustment, and we would like to emphasize the importance of increasing the national savings/GDP ratio by 6 percentage points through public sector fiscal consolidation. Equally important is the restructuring of the NPC.

We would appreciate staff comment on the inclusion of the ratification of the WTO agreement in the conditionality attached to the conclusion of the second program review. Is this clause specific only to the Philippines or will it be included in other Fund-supported programs?

With these remarks, we hope that the Philippines will be able to achieve external viability and to graduate from the use of Fund resources.

Mr. Posthumus said that the comments of previous speakers had confirmed his view that the program in support of the Philippines' request was neither impressive nor based on a convincing balance of payments need. The latter aspect was particularly disappointing in view of requests by a number of Directors, including himself, to look somewhat closer into the issue. He had to confess that he did not understand why management had proposed a decision on the arrangement to the Board, but he would not oppose it.

The situation with respect to inflation was not clear, Mr. Posthumus remarked. Mr. Tetangco had stated that it remained at single-digit levels; that was not borne out by the staff report, which indicated inflation was above the single digits and perhaps increasing.

At the last discussion on the Philippines a few Directors had indicated that they would not look favorably on a program in the future, Mr. Posthumus recalled. He would have liked to see some mention of that in the staff report.

He hoped that his impression that the structural part of the program was also back-loaded was incorrect, Mr. Posthumus stated. More specifically, according to his sources, the agricultural reform program was going slowly and, so far, was not very successful.

On the capacity to repay the Fund, there was no indication that Directors should have concerns in that regard, Mr. Posthumus observed. On the basis of the data provided by the staff, however, he was not convinced that a specific repayment schedule represented a low percentage of total debt. Whether that was true depended completely on the level of total debt, and that information could not easily be found in the documentation. While he questioned the staff's argument in that regard, he was not concerned about the Philippines' willingness and capacity to repay the Fund.

Mr. Tetangco observed that while he had cited the average inflation rate for January-May, which remained under 10 percent, the staff report cited the rate as of May, which was about 10 percent. Both agreed that some inflationary pressures had been felt in recent months, but that those pressures had not led to a high rate of inflation.

The staff representative from the Southeast Asia and Pacific Department said that inflation under the program was expected to decline from a monthly rate of about 10 percent on a seasonally adjusted basis during the first half of 1994 to about 6 percent by yearend, which was closer to the regional average. Several factors favored that development. The most important was that the program provided for tight monetary and fiscal policies. With the expansion of monetary policy, the buildup of inflationary pressures during the second half of 1993 should begin to dissipate. The staff's projections indicated that inflation would decline during the second half of 1994 to about 6 percent by yearend on a month-over-month basis.

As to the comprehensive agricultural reform program, when initiated under the administration of President Aquino, the program had had a slow beginning, but under the current administration the program had been revitalized and the distribution of land was increasing, the staff representative observed. The staff understood that the authorities were committed to carrying the program even more vigorously than at the beginning.

On capital inflows and the competitiveness of the exchange rage, it should be recalled that the Philippines had a large external sector, but a very small domestic financial system, the staff representative continued. In practice, a large increase in international reserves relative to the base money meant that the Central Bank would find it necessary to engage in some sterilization. That process initially would lead to some pressure on the exchange rate, as had happened in March/April. However, the sterilization policies--tight monetary policies--were considered important to bring down inflation; for example, with tight monetary policies under the 1991/92 stand-by arrangement, the rate of inflation declined from about 20 percent at the onset of the program during the first quarter of 1991 to about 8 percent by the end of 1992, and interest rates declined from about 30 percent to 16 percent over the same period. The current program provided for an initial rise in interest rates because of monetary tightening, but as inflationary pressures abated, as the fiscal position improved, and as demands on domestic financial resources by the public sector were reduced, interest rates should decline and the pressure created by capital inflows should abate. In the interim, exporters might face some problems, but there was no evidence that exports were not competitive. Moreover, the recent appreciation of the peso should be seen in the context of the sharp depreciation of the peso the previous fall.

The NPC, the largest public sector corporation, was sustaining some large deficits, which were being financed by subsidies from the National Government and by indirect subsidies through the OPSF, the staff representative commented. There were two major causes for the poor performance of the NPC. In the past two years there had been a need for a sharp and accelerated program of investment in power generation to overcome power shortages, which were suffocating economic activity. The second factor was the weak financial structure of the NPC. In the past, inadequate tariff adjustments had led to reliance on borrowing, and a great deal of the

NPC's revenue was being consumed by debt service. That factor, together with the bunching of investment in power projects as well as the need to maintain and rehabilitate some old power plants, meant that it would be difficult to avoid large losses by the NPC in the immediate future. However, there was a program to restructure the NPC, including the reorganization and privatization of some regional corporations within the context of the overall energy sector plan. The World Bank was heavily involved, together with other donors, in that project.

A question had been raised regarding local government units and whether the devolution program would lead to a transfer of the deficit from the national government level to the local government level, the staff representative recalled. The Local Government Law undertook the transfer some revenue-sharing arrangements to the local governments, together with certain activities and personnel. Those transfers were made on the assumption that local governments would be more attuned to local needs and would be able to make a more positive contribution to the development process. The activities transferred included health services and the maintenance and construction of rural roads. The Government would continue to transfer activities and personnel to the local level. Traditionally, the local governments operated on a balanced budget. With close supervision by the National Government, the restructuring of government expenditure plans, and the assistance of the World Bank, the local government units were not expected to incur deficits or to contribute to the public sector deficit.

The question of contingency plans to deal with possible slippages, given the challenging fiscal reform agenda, was present in the minds of the authorities, the staff representative from the Southeast Asia and Pacific Department observed. Some problems that were not fully explained in the program were, in fact, being worked on at the National Government level. For example, revenue projections did not indicate a great deal of improvement in revenues owing to improved tax administration, but efforts to improve tax administration were ongoing, including technical assistance programs for that purpose. Another possible contingency measure was some reform of the personal income tax to improve its yield. In addition to the minimum business tax, reforms of the corporate income tax were expected. All those efforts were directed toward enhancing revenues and eliminating inefficient or distortionary taxes. Moreover, wage increases, the first installment of which had been effected in the 1995 budget, would be implemented in line with improvements in the Government's revenue position. If revenue performance was falling behind schedule, the authorities might consider postponing some of the planned adjustment in wages.

The staff representative from the Policy Review and Development Department, commenting on whether the inclusion of ratification of the WTO agreement would become a standard structural measure in Fund-supported programs, said that the answer was "no." That action had been included in the Philippine program as a key structural measure, together with other trade measures, including the "elimination of agricultural quantitative restrictions," because the authorities had indicated that they would be ratifying the WTO agreement before a particular review date.

The staff representative from the Southeast Asia and Pacific Department, commenting further on the inclusion of WTO ratification as a structural measures, said that the authorities were trying to address the issue of "the Magna Carta" for small farmers, a law which had expanded the range of agricultural quantitative restrictions. An international treaty that in a sense rendered some quantitative restrictions invalid would aid the authorities in their removing such restrictions. They had therefore chosen to place ratification of the Uruguay Round agreement on the fast track. The agreement was expected to be ratified in the fall, and any laws that were inconsistent with the agreement would be simultaneously amended. That would give the authorities the opportunity to remove all quantitative restrictions.

Mr. Dorrington observed that the fact that the key structural measures contained actions ranging from those absolutely essential to the program to those that were intended and desirable but perhaps not absolutely essential underlined the point that it would have been useful to have performance criteria and structural benchmarks or, if that was not possible, at least some indication of the status of the various measures.

Mr. Tetangco, commenting on the Financial Times article cited by Mrs. Wagenhoefer, recalled that despite the number of arrangements with the Fund, the Philippines had paid all of its obligations on time, even at the height of the foreign exchange crisis in the mid-1980s. Moreover, Fund exposure to the Philippines had declined since 1991, and if the total disbursements available under the extended arrangement were drawn, the Fund's exposure would still decline by the year 1997. In terms of the revolving character of Fund resources, there had been net repayments on the part of the Philippines to the Fund.

He was grateful to Directors for their support for his Philippine authorities' request for an extended arrangement and also for their comments and suggestions on the medium-term strategy, which he would convey to Manila, Mr. Tetangco continued. One only needed to go to Manila to see the change in the overall mood in the Philippines, from one of uncertainty about whether the appropriate policies could, in fact, be put in place, to growing optimism and confidence about the political situation and the country's economic future.

The economic outlook had certainly brightened with the acceleration of GNP growth and the achievement of a manageable inflation and balance of payments situation, Mr. Tetangco stated. Further improvement was expected with the implementation of policies as specified in the Government's memorandum, which focused on fiscal consolidation, macroeconomic stabilization, and further economic liberalization. In that regard, past suggestions of the Fund's Executive Board had been taken on board by the Philippine authorities.

In the area of fiscal policy, several measures had been taken in 1993 and 1994, Mr. Tetangco observed. The plan to adopt further measures aimed at strengthening public finances, as indicated in the staff report, presented a formidable agenda on the fiscal side. As to benchmarks and performance criteria, it should be noted that economic managers in the Philippines came from the executive branch of government, and they recognized that the program of policy reform would have to go through a process of congressional approval. In that regard, they valued the more productive relationship that had developed between the Government and Congress, and his authorities would not want to upset that relationship, because they believed that that was the best way of pushing the reform effort.

It was true, as a number of Directors had mentioned, that the political situation in the Philippines had greatly improved, Mr. Tetangco remarked. The more productive working relationship between Congress and the Government reflected the desire to achieve, through appropriate policies, a higher rate of growth to meet the demands of a growing population and thereby allow the Philippines to participate in a more significant way in the dynamic development taking place in the region. To use a golfing metaphor to describe the Philippine performance: the Philippines had had some good holes and perhaps one too many bad holes, and in its economic experience it had hit the rough probably more often than it would have wanted; but it had started to improve its game and had begun to play well consistently, and it hoped that it would continue to do so and that that would lead to a better score for the Philippines.

His authorities had always valued the advice and assistance of the Fund and particularly wished to express their appreciation for the support extended at the current stage, when the economy was about to cross the threshold to higher growth under a democratic form of government, Mr. Tetangco stated. The staff had worked hard to reach an agreement around which the Government had wanted to establish a stable political consensus. The Fund staff team had been helpful in the entire process, even meeting with the key legislators to discuss economic policy and explaining the importance of a strong fiscal position to achieving the country's development aspirations.

The Acting Chairman made the following summing up:

> Executive Directors were in general agreement with the staff appraisal. They noted the long efforts to open and deregulate the economy, the progress thus far, the achievement of greater political consensus in favor of reform, and the new confidence shown by international investors. The Philippines was now in a position to move onto a path of sustained economic growth similar to that of a large number of neighboring countries in the region. Directors encouraged the authorities to seize this opportunity, underlining that this would require resolute and full implementation of the authorities' medium-term plan of stabilization and

economic reform, and that there was no room for slippages from the established timetable. Indeed, a number of Directors stressed that the reforms should be accelerated and strengthened in several areas.

Foremost among the policy requirements for sustained growth was the maintenance of a stable macroeconomic environment. Directors noted that the implementation of monetary and fiscal policies in past years had been uneven, which fueled uncertainty, and discouraged savings and investment. This pattern had continued into 1993, when expansionary policies had reversed some of the gains in the fight against inflation that had been achieved during the previous two years. Accordingly, Directors emphasized the importance of a renewed and sustained effort to reduce inflation, noting that this was the only way to achieve a durable decline in interest rates, maintain competitiveness internationally, and lay the basis for higher rates of economic growth.

Directors supported the authorities' plans for fiscal consolidation, noting that the deficit reduction was to be achieved through durable measures to reform the tax system and restructure government expenditure, and that this constituted the best policy response to the problems posed by the surge in capital inflows. In this regard, several Directors expressed concern about the back-loading of the fiscal adjustment, stressing that more front-loading would strengthen the credibility as well as the impact of the program. In the absence of more up-front, rapid adjustment in the fiscal deficit, the burden of restraining aggregate demand would fall on monetary policy, and produce a policy mix that was likely to add to the upward pressure on the exchange rate, with adverse consequences for exports and the viability of an export-led growth strategy. However, a few others expressed the view that a sharper adjustment could not be justified at this time, and that tax reforms and other fiscal consolidation measures are being implemented.

Directors, looking to the medium term, emphasized the importance of adhering to the fiscal targets planned for 1995 and beyond, with a focus on raising domestic savings and restructuring public expenditures to make room for an increased level of investment in needed infrastructure. This would require that revenue and expenditure measures be formulated--and political support mobilized--well in advance of the envisaged adoption dates, so as to allow sufficient time for the measures to be approved by Congress. Prompt action will be especially important to ensure that the minimum business tax, the civil service restructuring, and the Local Government Unit devolution programs can be introduced in line with the planned schedule. Regarding the civil service restructuring, it was suggested that emphasis be placed first on reducing the number of employees before undertaking wage adjustments. However, it was also recognized that the authorities had to address the problem of losing skilled staff in some parts of the public sector.

Directors expressed concern about the poor financial performance of the National Power Corporation. They stressed that this company should operate on a commercial basis, and that the various subsidies keeping it afloat in recent years would need to be phased out. In view of the deep-seated nature of the company's problems, however, Directors believed that this would require a comprehensive restructuring, and they urged that this process be implemented quickly. Meanwhile, it would be critical to ensure that the recently introduced automatic price adjustment mechanism keeps the company's deficit under firm control.

Directors welcomed the recent moves to establish a competitive and efficient financial system. They noted that the restructuring of the Central Bank will serve to strengthen its credibility and the independent conduct of monetary policy. Several Directors stressed the importance of maintaining firm control over liquidity, and expressed some concern about recent rates of growth of base money. Directors suggested that the liberalization of foreign bank entry should reinvigorate the small and slow-growing banking system, and a few urged the authorities to consider further liberalization in order to reap more fully the benefits from international competition and standards.

Directors endorsed the authorities' efforts to expand opportunities for the private sector and further open the economy. They particularly welcomed the revitalization of the privatization program, the decision to widen the areas of economic activity open to full foreign ownership, and the recent tariff reduction plan. Directors stressed the importance of an early ratification of the World Trade Organization Agreement and the related lifting of quantitative restrictions on agricultural products. Directors considered that the plan to increase the frequency and automaticity of domestic oil price adjustments starting in September constituted an important step toward the deregulation of this sector. Some Directors, however, urged that full liberalization of the oil sector take place on a faster timetable, noting in particular the distortive effects of the OPSF and recalling earlier periods when prices were not adjusted adequately. More generally, it was noted that the task ahead for structural reforms remained considerable, with a need to address structural distortions and market rigidities in several areas, which constitute impediments to growth and poverty alleviation.

Directors remarked that past reform efforts had contributed to a substantial strengthening of the external position. The export base had expanded considerably, the debt-service burden was now manageable, and following the restructuring of commercial bank obligations, the country had regained access to international capital markets. Directors stressed that it was therefore both feasible and critical for the Philippines to attain external viability in the very near term, and to maintain it through a cautious commercial borrowing strategy aimed at ensuring that the debt-service burden continues to decline. A number of Directors felt that the Philippines should now graduate from the rescheduling process, and that this would improve both the terms and access of the Philippines to international capital markets. Others felt that the liberalization effort should continue to be adequately supported by the international community, in view of the uncertainty of the external position owing to oil price developments and the potential volatility of capital flows.

Directors noted with satisfaction that the Philippines' exchange system is virtually free of restrictions. They encouraged the authorities to quickly remove the few remaining restrictive practices, and thereafter to move to Article VIII status in the Fund.

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

The Executive Board took the following decision:

1. The Government of the Philippines has requested an extended arrangement in an amount equivalent to SDR 474.5 million for the period from June 24, 1994 to June 23, 1997.

2. The Fund approves the extended arrangement set forth in EBS/94/117, Supplement 2.

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

Decision No. 10720-(94/57), adopted
June 24, 1994

After adjourning at 12:50 p.m., the meeting reconvened at 2:30 p.m.

2. NICARAGUA - 1994 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1994 Article IV consultation with Nicaragua and Nicaragua's request for arrangements under the enhanced structural adjustment facility (ESAF) (EBS/94/116, 6/3/94). They also had before them a background paper on recent economic developments in Nicaragua (SM/94/148, 6/14/94) and a policy framework paper for 1994-97 (EBD/94/93, 6/3/94).

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

> This statement provides additional information on the treatment of Nicaragua's external debt to official bilateral creditors under the program to be supported by the proposed ESAF arrangement, including the treatment of the claims of the Russian Federation, a major creditor of Nicaragua.
>
> A Paris Club meeting is expected to be held in September, and agreements between Nicaragua and certain non-Paris Club official bilateral creditors have been concluded. Also, negotiations are under way or are expected to begin in the near future with remaining non-Paris Club official creditors.
>
> As regards Paris Club debt, the program anticipates a rescheduling on enhanced concessional terms; in addition, Paris Club creditors are expected to provide substantial financial assistance to Nicaragua in the form of grants and loans. Non-Paris Club official bilateral creditors with whom debt-restructuring agreements have been reached have tended to opt for substantial debt forgiveness, while providing considerably less assistance in the form of grants and loans than has been provided by Paris Club creditors.
>
> For those non-Paris Club official creditors with whom debt-restructuring agreements have yet to be reached, the program assumes financial relief broadly similar to that already agreed with other non-Paris Club creditors. It should be emphasized that these are only working assumptions, as the eventual terms of the agreements will be the subject of bilateral negotiations between Nicaragua and its creditors. The financing assumptions of the program are compatible with a variety of terms with regard to the amount of debt reduction, the schedule of payments, and new cash financing.
>
> Regarding the treatment of arrears in the program, in line with Fund policy on financing assurances, the limits on the stock of arrears exclude arrears pending negotiation. This exclusion relates primarily to commercial bank creditors and does not cover arrears to official bilateral creditors. The debtor is expected to eliminate arrears to bilateral creditors by rescheduling or cash settlement within the period specified for the conclusion of bilateral agreements in the Paris Club Agreed Minute--usually six to nine months after the date of the Agreed Minute. Under Fund policy, overdue payments on reschedulable obligations to Paris Club and non-Paris Club official bilateral creditors will not be

considered arrears for the purposes of the program during this period.

Furthermore, negotiations between Nicaragua and its non-Paris Club creditors are expected to advance at the same time as bilateral discussions with Paris Club creditors. As noted, a Paris Club meeting is expected to be held in September, and negotiations with non-Paris Club creditors are continuing or are to be initiated soon; discussions on reschedulings and debt operations with the Russian Federation are expected to begin in July. If the anticipated bilateral agreements are not concluded by the end of the specified period, arrears may re-emerge for the purposes of the program, unless the Fund judges on the circumstances of the case that the debtor country has made its best efforts to reach such agreements with its creditors.

The efforts of adjustment and reform that are being undertaken by Nicaragua to lay the basis for a sustained economic recovery require substantial support for investment, and thus the country will continue to incur large deficits in the goods and nonfactor services account of the balance of payments over the next several years. In addition, the country is burdened with heavy repayment obligations and the need to eliminate external payments arrears. Therefore, the exceptional financing needs of Nicaragua are large. As noted in the staff report, the exceptional financing needs for 1994 would amount to $4.25 billion, or more than two times the GDP of Nicaragua. To achieve external viability over the medium term, Nicaragua will require highly concessional debt restructurings as well as continued concessional support from donors. Indeed, in cash flow terms, the program assumes that the bilateral creditors as a group will provide net financing to help cover the deficits on the goods and nonfactor services account of the balance of payments.

Extending his remarks, the staff representative said that since the circulation of the staff report, additional information had become available indicating that consumer prices had risen by 3.4 percent in the first five months of the year, or at an annual rate slightly below the increase of 10 percent envisaged in the program for 1994. Preliminary estimates pointed to a significant recovery of output in agriculture and construction during the first five months of 1994, and the authorities believed that real GDP growth could exceed the increase of 2 percent assumed in the program.

In the period January/May 1994, central bank credit to the nonfinancial public sector had remained within the program limits, while the losses of the Central Bank had been lower than programmed, the staff representative continued. At the same time, net central bank financing of commercial banks had declined because of lower-than-expected lending by the state-owned banks and improvements in loan recoveries. Net international reserves of the Central Bank had increased somewhat more than envisaged in the program.

In May, the mechanism under which central bank interest rates were set on the basis of market rates was extended to all credit operations of the Central Bank, with the exception of loans under existing contracts, the staff representative stated. Early in June, the Government had initiated the monthly adjustment in gasoline prices contemplated in the program. In the area of privatization, the Government had recently submitted to the National Assembly a proposed law that would establish a regulatory framework for the telecommunications sector and permit the privatization of the state telecommunications company (TELCOR).

Based on indications provided by donors at the consultative group meeting held in Paris on June 16-17, 1994, the financing for the first-year ESAF program seemed to be assured, the staff representative from the Western Hemisphere Department remarked. In particular, three donors had confirmed their readiness to provide parallel financing for the Economic Recovery Credit II from the International Development Association (IDA). In addition, several donors had expressed interest in contributing to the buy-back of Nicaragua's debt from commercial bank creditors, provided that appropriate burden-sharing arrangements were made. Moreover, on June 21, the Executive Board of the World Bank had approved the Economic Recovery Credit II for an amount of SDR 42.5 million.

Mr. Marino made the following statement:

> The Nicaraguan authorities wish to convey their gratitude for the continued support and advice that both the management and the staff of the Fund have provided on numerous occasions, leading to the present Article IV consultation and the request for an arrangement under the enhanced structural adjustment facility. My authorities also wish to express their appreciation to the international community for the new commitments of financial assistance pledged at the recent consultative group meeting in Paris.
>
> The current Administration, which took office in April 1990, inherited a large public sector, a small and over-regulated private sector, and a weak institutional base. The macroeconomic situation had weakened markedly owing to inadequate economic management, adverse external factors, and a prolonged civil war. Macroeconomic imbalances were reflected in hyperinflation, a depletion of international reserves, and a substantial accumulation of external debt. Since 1991, the Government has implemented a comprehensive stabilization and structural reform program to transform the centrally planned economy to a market economy. Its major achievements include a deceleration of inflation from 13,500 percent in 1990 to 4.5 percent in the post devaluation period May-December 1991 and to 3.5 percent in 1992, and the stabilization of real GDP, which fell only slightly in 1991, increased by 0.4 percent in 1992. Additionally, the Government cleared its arrears with the World Bank and the

Inter-American Development Bank, and reached a Paris Club agreement on favorable terms.

Despite adverse conditions on both the economic and political fronts at the beginning of 1993, such as the reduction in external assistance, drought conditions, unfavorable prices for key export products, the adjournment of the National Assembly, and the resurgence of guerrilla activity in the countryside, the Government continued implementing prudent fiscal and monetary policies in order to maintain macroeconomic stability.

The policy measures included actions to strengthen the savings performance of the public sector by a mix of revenue and expenditure policies, and the implementation in February of a crawling peg system after a 20 percent devaluation of the cordoba. Furthermore, the Government continued with the divestiture program and with the personnel downsizing of state-owned banks in order to reduce their operational losses.

These actions succeeded in maintaining price stability. Consumer prices, after increasing by almost 18 percent following the devaluation of the cordoba in February, rose by only 1.5 percent during the rest of the year. However, real GDP declined by 0.9 percent and international reserves fell by $100 million, limiting freely usable reserves to only $55 million, or less than one month of imports of goods and nonfactor services. It is worth noting that external assistance dropped by almost $300 million from 1992 to 1993.

The economic outlook for 1994-95 is somewhat improved: the National Assembly has started functioning, rural violence has diminished, key international commodity prices have rebounded, and climatic conditions have been favorable. Despite these positive factors, the external situation remains weak and dependent on concessional financing.

The program's main objectives are to place the economy on a sustainable path of growth led by the private sector, to reduce the inflation rate to 5 percent a year by 1997, and to strengthen international reserves to the equivalent of 3 1/2 months of imports of goods and nonfactor services by the end of 1996. The strategy for attaining these objectives includes an improvement in the public finances and prudent credit, wage, and exchange rate policies.

The authorities see the fiscal effort as the centerpiece of their program. During 1994, the savings of the combined public sector, excluding net interest paid, will increase to 9.4 percent of GDP, or, after interest, to 4.2 percent of GDP, from 1.9 percent of GDP in 1993. Several measures were adopted since late 1993 to enhance current revenues by 1.8 percentage points of GDP in 1994, including a reduction in import duty exemptions; a broadening of the base of the tax on luxury consumption; an increase in fees on visas, passports, and forestry licenses; and stiffer penalties on arrears. Steps have also been taken to improve the customs administration and sales tax compliance outside the Managua area. Gasoline prices were adjusted by 25 percent in the period July-August 1993 and by a further 2 percent in January 1994. Moreover, this month the Government implemented a mechanism of monthly adjustments on gasoline prices to keep them unchanged in U.S. dollar terms. In order to improve the finances of public utilities, tariffs were increased for telephone, water and sewerage, and electricity services, and reductions in employment and other operating expenditures will be put in place later this year.

On the expenditure side, several measures have been programmed that will reduce current expenditures by 1.3 percent of GDP. These measures include a reduction of 7,000 public sector employees in 1994, with a targeted total reduction of about 13,500 by 1996; a freeze of public sector wages and salaries; the closing of certain government entities; a further reduction in military personnel; and the containment of transfers to health and education. Central bank losses are also being reduced by 0.5 percent of GDP through the introduction of a commission on foreign exchange sales, by actions to improve the recovery of interest payments from the commercial banks, by the alignment of central bank interest rates with the market, and by stricter procedures regarding interest payments from the National Investment Fund (FNI).

Monetary policy will be in line with the inflation and balance of payments objectives. The Central Bank has designed a prudent credit policy that allows an increase of 10 percent in broad money. Credit to the private sector could be expanded by 10 percent during 1994, owing to the planned reduction in the net indebtedness of the nonfinancial public sector with the financial system. In addition, there will be no central bank financing to state-owned banks, and the financing to the FNI will be limited to the relending of external resources. Interest rates will be kept free of controls.

In the external area, the main thrust of the authorities' reform effort is to reduce the heavy dependence on external assistance. However, the external situation will remain fragile, and its viability will depend on continued significant donor support. The program envisages a reduction of the current account deficit from 24 percent of GDP to 22 1/2 percent of GDP in 1994, and to 20 percent in 1995. Exports are expected to grow by 11 percent, as a result of higher international coffee prices and strong growth in nontraditional exports. Imports will remain at the same level. The capital account deficit is expected to increase during 1994, owing to a substantial increase in the amortization program and should record a surplus in 1995. The projections include a reserves buildup of $45 million and $35 million for 1994 and 1995, respectively; however, the financing needs will remain high over the medium term.

The extraordinary financing needs amount to $4,180 million in 1994 and $560 million in 1995. My authorities are negotiating a concessional rescheduling from Paris Club creditors and debt relief from non-Paris Club official bilateral creditors. They have also intensified their efforts to find arrangements that would allow them to reduce their debt with the foreign commercial banks.

Exchange rate policy will be closely monitored to ensure that balance of payments objectives are achieved. As mentioned before, the Government adopted a crawling peg system that aims at ensuring export competitiveness and promoting investment in the tradable goods sector. In view of the fragile external situation, exchange and trade restrictions remain in effect; however, the Government has agreed to eliminate some of these restrictions by the time of the first-year review of the ESAF arrangement.

With regard to structural reform, the staff papers clearly set out the Government's objectives and strategy over the medium term. In brief, the objective is to consolidate the process toward a market-based economy through measures in the areas of property rights, privatization, the financial system, and the labor market. These measures also constitute conditions within the recently approved Economic Recovery Credit II from the IDA.

My Nicaraguan authorities recognize that much remains to be done, and they are committed to persevering in their efforts to ensure the successful implementation of the economic program. They are confident that the full implementation of the program in support of the ESAF arrangement will establish the foundation for sustained noninflationary growth and the improvement of Nicaragua's social indicators. They hope that this extraordinary domestic effort will be supported by adequate and timely financial assistance from the international community, in view of the large external financing needs of the Nicaraguan program.

Ms. Lissakers made the following statement:

We welcome and support this important program in support of an ESAF arrangement, as well as the extensive effort by the authorities, by the staff, and by management that has brought it about.

This arrangement comes at a crucial time for Nicaragua. The negotiations have been protracted, but we are beginning to see signs of life and hope in the Nicaraguan economy. Our hope is that the conclusion of these negotiations and fulfillment of the program will boost the growth and reform effort that is now seriously under way.

As the staff has noted, in the past few years Nicaragua has made substantial progress in stabilizing the economy and initiating some structural reforms, primarily under the earlier stand-by arrangement. Among other achievements, inflation was brought under control, the exchange rate was stabilized, budget deficits were reduced, and the Government was pared back. The number of public sector employees, for example, was reduced from nearly 300,000 in 1990 to 100,000 by the end of 1993. The demobilization of the defense forces has been particularly dramatic, with total troops reduced from about 100,000 to 15,000 at present. This is a difficult and noteworthy accomplishment under the circumstances. Budgeted military expenditures have fallen from 22 percent of GDP in 1990 to under 3 percent at present. At the same time, privatization and financial sector reform has begun, and trade barriers have been lowered or abolished.

Nevertheless, by late 1993 the external position was extremely difficult. The political situation also was not conducive to further implementation of needed reforms. Growth has been stagnant--nonexistent in effect. As a result, per capita income, living standards, and overall infrastructure development have remained among the worst in the hemisphere.

Against this background, conditions now seem more propitious for advancing the reforms so desperately needed to address pressing problems in Nicaragua and to put it on a path of sustainable growth.

On the policy front, the staff's update seems to indicate that the economy is beginning to show signs of life, particularly with an important rebound in the agriculture sector and in construction, which can generate jobs. The authorities are moving ahead to implement the program. In addition to the positive economic signs, the political system also seems to be functioning better with dialogue and a degree of cohesion on what policy measures need to be undertaken. In this context, I want to particularly praise the efforts of the staff and the Managing Director's useful intervention to try to explain the program to a broad spectrum of interest groups in Nicaragua. I commend the Government as well for its efforts to explain the need for these painful reforms and their potential benefits. I think this is the way members and this institution should proceed with every program to try to demystify it, and to try to build broad political support. That is how we can best serve our members; that, I think, is indeed the policy, and I welcome it.

In recognition of the increased commitment to reform, bilateral and multilateral donors have pledged substantial assistance in support of the Government's economic program and the ESAF arrangement. I know that a number of donor countries, including Japan, have come forward in a timely manner to support the authorities' program. Therefore, at this critical juncture, the Fund's financial support and policy advice is playing a crucial role in helping the authorities to jump-start the economy. As I generally agree with the staff appraisal and support the key policy actions under the ESAF, I will comment on a few issues of particular interest.

The incipient signs of economic recovery are encouraging. I agree with the staff that strict adherence to the fiscal and monetary targets under the program will play a critical role in creating an environment more conducive to increased investment, employment, and output. I endorse the policy intentions in those areas. In the fiscal area in particular, it is worth noting that bilateral assistance is likely to diminish from its recent high levels in the outyears. As a result, efforts to control and increase the flexibility of expenditures, expand revenue collection, and make other fiscal adjustments are likely to be needed for some time to come.

Outside the realm of fiscal and monetary policy, significant impediments to growth and employment-creating private sector activities remain. I am pleased to note that the program under the ESAF contains a number of commitments to reduce or eliminate these impediments. Among those worthy of special attention are efforts to strengthen property rights, bolster the financial sector, accelerate privatization, and resolve Nicaragua's external debt overhang. I know that the staff has focused particularly on reform to large state development banks, and that some progress has been made in this area. We look for further steps to strengthen the performance and the creditworthiness of these institutions.

Among Nicaragua's remaining impediments is the large, weak, and inefficient public sector. I am pleased to see the steps contemplated under the arrangement to continue reducing the Government's role in the economy, but would urge that efforts be expedited and expanded where possible. I have noted the importance of the financial sector reform where state banks are pared back, and property and securities issues are resolved. I also hope that the private banking sector can begin to play an increasingly important role in the financial system.

Regarding other sectors of the economy, Nicaragua's efforts thus far at privatization have been useful, but an accelerated effort is warranted to divest the remaining enterprises under state control and pass the legislation necessary to permit the process to move forward. The upcoming partial privatization of the state-owned telecommunications company will be an important milestone in the privatization program, and I am pleased to hear that the necessary legislation has been sent forward. I would urge that full privatization be considered down the road and that similar entities be put on the block if possible.

As the staff notes, in line with the general need to bolster weak legal structures and institutions, efforts to strengthen property rights will be critically important to improving confidence and boosting domestic and foreign private investment. Nicaragua has recently accelerated its efforts to resolve the many outstanding property and expropriation cases, but a substantial backlog remains. Every effort must be made to return seized properties to their rightful owners or, at a minimum, to provide reasonable compensation. For my authorities--and I believe for many others--progress on this front will be an important factor in decisions regarding bilateral assistance and further support for lending by international financial institutions. I should also note that, to the extent that compensation is provided, it must fit within the parameters of the fiscal and monetary targets under the arrangement. Therefore, we urge that privatization receipts be relied upon to the greatest extent possible in financing compensation, beginning with privatization of TELCOR as scheduled in the program.

Nicaragua has an enormous overhang of external debt that must be dealt with in order to enhance growth prospects. The Paris Club and some non-Paris Club creditors have already assisted Nicaragua. Another round of relief from the Paris Club later this year will be helpful as well. Nicaragua and its remaining creditors must make every effort to reduce the external debt burden and to normalize international financial relations.

I would like to raise an issue that is applicable not only to the Nicaraguan situation but is becoming a common feature of programs coming before this Board--the question of labor market reforms. The Board discussed this particularly vigorously in regard to the industrial countries. Nicaragua has made commitments both to the Fund and to the World Bank to undertake certain changes in its labor code. I would like to raise a cautionary flag in this context. It is one thing to talk about "labor market flexibility" in a context or in a country where democratic institutions are firmly anchored, where the social safety net is extensive, and where organized labor is strong and worker rights well protected. It is quite another when we begin to address these issues in a context where democratic institutions are weak, where the social safety net is flimsy or nonexistent, where worker rights historically have been subject to abuse, and the bargaining power between business and labor, and employers and employees, remains uneven at best.

Certainly, there are impediments to employment, and the Fund should try to address these in programs. It is apparent in Nicaragua and many other developing countries. But I would simply say to the Fund--although it is probably even more important in the Bank context--that we need to be very careful to avoid weakening what there is of worker rights in the name of greater labor market flexibility.

The Chairman said that he agreed with Ms. Lissakers' point regarding issues of labor market flexibility. He wished to assure her that the staff had not, in fact, applied as much pressure in its discussions of that issue with Nicaragua as it would have in discussions with, say, France or Sweden. Rather, in mentioning the need to go in the direction of labor market flexibility, it had stressed the extreme importance of the traditional tripartite approach whereby strong, legitimate, democratically elected labor unions discussed the main thrust of social and economic policies with the Government and with business representatives.

Mr. Kanada made the following statement:

There have been some improvements in economic performance as a result of the economic adjustment efforts begun in 1991. In particular, the sharp drop in inflation in 1992 was remarkable. However, as noted in the paper, the adjustment process and momentum of reform were not maintained in 1993. Consequently, there have not been any sign of economic recovery, except for an improvement in the external current account. Above all, the external debt outstanding was about six times as great as GDP in 1993. Gross foreign reserves amount to only about 1.5 months of imports. Thus, the external position is extremely precarious and a cause for serious concern.

In view of this difficult situation, I am pleased to note that the authorities have established and are firmly committed to a medium-term program for structural reform. Although the authorities initiated a comprehensive adjustment program in 1991, there remain a number of challenges facing the authorities for the short term, as well as medium term and long term. In this connection, the authorities are just at the starting point as they embark in earnest on this medium-term comprehensive structural reform program. In view of the current difficult political and economic situation, it is important for the authorities to implement firmly and steadily the planned measures under the program so as to regain their credibility and obtain the necessary assistance from external creditors.

In addition, as political and social stability is crucial for the attainment of economic recovery, the domestic peace process should be accelerated.

As I am in a broad agreement with the staff's appraisal, I will just make a few brief comments for emphasis.

As social issues such as poverty and unemployment play a key role in stabilizing the economy, priority should be given to social stability. It is especially important to try to reduce poverty. In this connection, it is reasonable that the program emphasizes the strengthening of the social safety net and that social expenditure is being increased in 1994.

As the debt burden is extremely large, external viability cannot be attained without substantial assistance from external creditors. Any existing arrears should be eliminated with a view to obtaining the necessary assistance, In addition, it is important for the authorities to show external creditors evidence of their adjustment efforts through the firm implementation of the program.

The authorities should recognize that there is no room for slippage or any deviation from the program, such as occurred under the last stand-by arrangement. Otherwise, the attainment of economic recovery and credibility will be undermined.

I hope that this program will be a first step toward economic recovery, and that the utmost efforts will be made to attain economic, political, and social stability from the medium- and long-term perspectives. I support the proposed decision.

Mr. Blome made the following statement:

We can, in principle, support the staff appraisal. Nicaragua's request for an ESAF arrangement raises a number of difficult questions. To begin with, I wonder whether one fundamental requirement for an ESAF arrangement--namely, the achievement of substantial progress toward external viability during the program period--can be met in this case. The external baseline scenario gives the impression that the imbalances in the balance of payments will remain high over the medium term owing to the country's substantial debt-service burden. The staff itself has pointed out that the proposed increase in Fund exposure will consequently carry considerable risks. Therefore, Nicaragua may not have a temporary, but rather a longer-term balance of payments problem. In the circumstances, the country might be considered a field of activity for the multilateral development banks rather than for the Fund.

It is self-evident that Nicaragua's economic problems can only be overcome by sustained comprehensive adjustment efforts over a relatively long period of time. Even if one agrees that Fund involvement is desirable in this context, inter alia, in order to facilitate debt-rescheduling negotiations and to ensure a stable macroeconomic framework as a prerequisite for structural reform, the question arises whether the authorities will be able to persevere with a far- reaching adjustment program. There are several reasons for doubt in this regard. First, the previous stand-by arrangement, which went off track after half a year, underscores that the country's administrative capacity is still relatively weak. Second, it may become difficult to muster and sustain sufficient public support for the necessary comprehensive reforms, in view of the polarization in domestic politics and the narrow majority of the present Government in the Congress. Finally, I understand from press reports that there are still problems in the area of "good governance" that could cause further delays in the disbursements of foreign aid, and thereby endanger program financing and implementation. In sum, the risks are substantial in this case, and the ESAF arrangement for Nicaragua should be seen as an exception rather than as a precedent for further arrangements.

As to the specifics of the program, I agree with the staff and the authorities that the strengthening of public sector savings, further privatization, and vigorous deregulation measures are essential for the success of the reform strategy. Against this background, I welcome the projected improvement in the savings position of the public sector to more than 5 percent of GDP in 1994, which should facilitate the financing of the ambitious public investment program. Concerning the latter, however, I note that public investment--at 14.2 percent of GDP in 1994--will remain relatively high as a share of GDP in the next few years. That raises the prospect that the country's limited administrative and absorptive capacity could be overtaxed. More generally, and in view of the need to promote the external adjustment process, I wonder whether the authorities should not aim at a distinct surplus in the overall fiscal balance after grants rather than a balanced budget. Such a surplus could be attained by a critical review of the initiated investment projects and by an accelerated implementation of the additional consolidation measures recommended by the staff.

On monetary and exchange rate policies, I would ask whether the combat against inflation could not be supported by a strengthening of exchange rate policies, namely, by a considerable reduction in the preannounced devaluation rate of 12 percent a year. There may be considerable room for such strengthening, as the inflation rate has already been reduced to 8.5 percent on an annualized basis in the first few months of this year.

I note that the spread between the official and the parallel market rate is relatively narrow, which may indicate that the present official rate is broadly adequate. The chart on page 10a, however, could give the impression that the current exchange rate is excessively overvalued and that early exchange rate actions are necessary in order to facilitate the difficult external adjustment process. Perhaps the staff could comment on this point.

As to external sector policies, I note that the rescheduling negotiations with Germany have proved difficult and protracted. Although I frankly admit that I do not understand every detail of the contentious issues, I would, nevertheless, underline the readiness of my authorities in principle to reach an early debt-rescheduling agreement with Nicaragua. I thus hope that the remaining questions can soon be settled.

On structural policies, I note that the Government, which took office in April 1990, has achieved only limited progress in the important area of property rights. According to the Government's new program, most cases of agricultural landholdings without clear title are to be resolved by June 1995, while the cases of urban lots without clear title will be settled by June 1996. As a rapid resolution of the property rights issue is essential to establishing the basis for private investment and growth, I would encourage the authorities to accelerate this process.

In response to a question by the Chairman, Mr. Blome explained that among the concerns expressed by his authorities regarding governance were reports of human rights violations in Nicaragua. If those claims were accurate, his authorities would like to see those violations ended.

Mr. Desruelle made the following statement:

Looking at the economic situation of Nicaragua today, one sees significant improvement since the adoption of the 1991 program under the stand-by arrangement. Yet--and this is a measure of the gravity of the situation that had been reached at the end of the 1980s--the road toward a balanced and sustainable growth and external viability remains long.

In this context, the presentation to the Board of this program in support of an ESAF arrangement is welcome. This program shows the authorities' commitment to deepening their stabilization efforts and to pursuing structural reforms. As such, it does deserve support from this institution. Moreover, this program has the potential to catalyze a substantial amount of resources from the international financial community.

As to the program itself, I understand from the staff report that a delicate balancing exercise between the various elements of the program has been undertaken to fulfill its objectives of stability and growth. At the risk of simplification, I see the outcome of this balancing exercise as follows: on the side of stability, there is the restrictive stance of the fiscal current account and the tightening of interest and credit policies. And, on the side of growth, there is the increase in public investment, largely financed by external grants and the exchange rate policy, which, as I understand, is geared to balance of payments objectives.

Looking at this policy mix, one is inclined to focus, perhaps unfairly, on the risks on both sides of the balance--the risks to stability and the risks to growth.

On the risks to stability, I am concerned about the implementation of exchange rate policy. I understand that, in light of the current account figures, competitiveness is an important issue. Nevertheless, the experience at the end of 1992 and early 1993 shows that a depreciation of the currency can rapidly translate into significant bursts of inflation. Therefore, there is a direct risk that too fast a rate of crawl of the nominal exchange rate could have a significant and immediate impact on inflation. Furthermore, there is an indirect risk that, through higher inflation, a fast rate of crawl might endanger the sustainability of the wage freeze in the public sector.

In this respect, I would welcome clarification of the following sentence in the letter of intent: "During the program period, the Government is committed to keep exchange rate policy under close surveillance to ensure that the balance of payments objectives of the program are achieved."

There are also risks to growth. Clearly, many measures have been taken and are envisaged that are favorable to growth in the medium term, particularly the measures to clarify property rights, increase public savings, encourage externally financed investments, and rebuild the financial system. In the short term, however, at least two developments may cast some doubt on the staff's growth forecast.

We know from our experience with Fund programs that the impact of fiscal consolidation on savings, investment, and ultimately growth is traditionally rather slow. Moreover, the necessary restructuring of the financial system, including the progressive elimination of directed credit from the Central Bank, can create, in the short term, significant financial difficulties for a number of domestic agents. This is, at least, what the experience of countries in transition in Eastern Europe and the former Soviet Union suggests. This phenomenon might be compounded by the high levels of interest rates presently prevailing on the market.

The actual prospects for growth could then raise questions about the sustainability of the efforts undertaken.

I note, nevertheless, that as agriculture plays an important role in the Nicaraguan economy, exogenous developments can have a significant impact on growth, which may counteract the effects mentioned above. In this regard, I welcome the positive information provided by Mr. Marino and by the staff at the outset of this meeting.

A few words on financial assistance from the international financial community: in 1991, when the authorities embarked on a courageous program of reform, they were supported by this institution and other multilateral creditors. Bilateral creditors also played an important role, either through direct assistance or, for Paris Club members, through a rescheduling on the most favorable terms available. As in the past, my authorities are ready to consider favorably a debt treatment in the Paris Club on such terms.

This being said, the detail in the staff report with respect to treatment of Paris Club and non-Paris Club debt is surprising, as the mention of specific figures may not be entirely helpful. Nevertheless, I agree with the thrust of the report that because maturities related to creditors that were not Paris Club members will remain high in coming years, the case for a treatment of that debt on generous terms is obvious.

Mr. Lvin made the following statement:

I would like to commend the authorities and the staff for the job they did in preparing the policy framework paper, and the accompanying papers, which, along with Mr. Marino's helpful statement, provide us with a clear view of recent developments and future tasks.

Nicaragua seems to be firmly on the path to recovery, since the time that central planning ceased and internal hostilities were terminated. The new Government has managed to start nationwide civil reconciliation, which has led to massive demobilization of different armed groups and forces. This bold decision was undoubtedly necessary precondition for putting state finances in order, bringing a devastating deficit and money expansion to an end, and commencing a more general economic overhaul.

This reform started from a point of extreme decay in the economy, thus allowing Nicaragua to avoid the significant decline in GDP and output that was common to other countries in transition at an early stage of transformation. However, this stability remains fragile, as Nicaragua faces sustained deterioration of per capita income--approximately 10 percent since 1991--which currently stands as low as $420. Mass poverty remains widespread, housing shortages are still drastic, and about a quarter of the population remains illiterate. Unemployment and underemployment, sometimes in the form of informal sector activity, affect half of the labor force.

The authorities are fully aware of these exceptional challenges, and are trying to do their best to overcome them. The seriousness of their approach is clearly evidenced by their courageous struggle against inflation. This struggle resulted in a rapid transition from hyperinflation lasting until 1991 to an environment of stable prices much more conducive to entrepreneurial activities. In fact, the outcomes of 1992--when prices rose only by 3.5 percent--and of 1993--when the rate of inflation turned out to be 19.5 percent, even less than the rate of devaluation of the cordoba--look impressive.

Such success on the monetary front certainly would not be feasible in the absence of a rather tough fiscal policy. Attainment of a more viable state budget, which appeared to be in deficit of about 7 percent of GDP before grants, but just balanced with these grants, should be regarded as a notable achievement of the authorities. The program to be supported by this institution under the ESAF arrangement foresees further courageous measures to be undertaken with, perhaps, more emphasis on the budget expenditures side. One must certainly mention a sizable reduction in public service employment, and containment of wages and pensions in this sector. Such a step would require a solid political support, and we encourage the authorities to make this issue a priority.

Some important steps have been made in the area of structural transformation. Evolving of a new private banks' network, along with elimination of direct controls over their credit policies, should be particularly mentioned. However, it seems that progress on this front could have been more impressive. For instance, existence of an extensive informal sector may be interpreted as reflecting still pervasive state regulation of economic activity. Public sector share in the economy still remains too large, thus threatening fragile fiscal stability and concentration of government activities on poverty alleviation and related issues.

Therefore, we are pleased to note that the program for 1995-1997 provides more opportunity in this respect. The politically and economically important--and undoubtedly the most sensitive--issue of divestiture of former, until recently, private entities, and compensation for their previous owners ought to be addressed.

This problem seems to be one of three impediments to wide and much needed foreign investment. Political instability is another. Resumption of the National Assembly must contribute to strengthening the political component of economic reform. External debt problems constitute a third barrier to private capital inflows. Indeed, while speaking on Nicaragua's program of economic transformation, one cannot avoid mentioning its unique challenge, namely enormous foreign indebtedness. I doubt that there are any other cases of countries with outstanding debt amounting to six times GDP. It is widely recognized that the debt burden should be reduced to a manageable level, and cash flow support is badly needed by the authorities.

In this respect, we take note of a very clear statement by the staff representative, indicating the arrangement under discussion requires an agreement between Nicaragua and official creditors to be reached not later than end-February 1995.

We urge the authorities to give careful attention to these negotiations, which are expected to begin shortly. The outcome will serve not only as a performance criterion of this program, but also as a starting point for a debt and debt service reduction operation with commercial creditors. This operation, in its turn, would pave the way to creation of more predictable and appealing environment for private foreign investment. And this could become a cornerstone of Nicaragua's recovery in the medium term.

With these remarks, let me express my full support for the authorities' program. I hope Nicaragua overcomes its challenges and returns to the sustainable growth so needed after years of suffering.

The staff representative from the Western Hemisphere Department said that it was true that in the past, there had been problems of under-execution in the public investment program. In 1993, however, capital outlays had increased to about 12 1/2 percent of GDP because of a strong investment effort, particularly during the second half of the year. As mentioned in the staff report, Nicaragua's infrastructure was in very bad condition, and the Government therefore attached great importance to its public investment program. Under the circumstances, the projection for 1994 did not appear to be out of line, although there could be delays in implementation. Based on investment in the first five months of 1994, however, and compared with program projections for the period January-May, execution had been on the order of 90 percent; in 1993 it had been on the order of 60 percent. That represented a significant improvement in terms of the capacity of execution.

As to the prospects for improving the fiscal situation by cutting capital expenditure, it should be noted that almost 80 percent of Nicaragua's capital expenditure was externally financed through grants or tied loans, while the remaining 20 percent corresponded mostly to local counterpart funds, the staff representative stated. Cutting the investment program was therefore unlikely to have a major effect in terms of allowing the nonfinancial public sector to reduce its net indebtedness with the banking system by a significant amount.

On exchange rate policy, the authorities considered that the current crawling peg system, which had been adopted following the January 1993 devaluation, had worked well, the staff representative observed. That view was supported to a large extent by the fact that the spread between the official and the free rate had remained on the order of 2 percent and by the gains in competitiveness since the adoption of the crawl. Since December 1992 the cordoba had depreciated by about 6 percent in real effective terms. At the same time, there had been a gradual decline in real wages, as pressures for increases in nominal wages had been limited. The experience of the one-shot devaluation, which to a large extent had been absorbed by prices, seemed to confirm that continuing with the crawl was a better option. The staff agreed that the authorities would have to keep the crawl under close review, and the program allowed flexibility for changing the crawl if conditions so warranted.

As to the program's requirements with respect to Nicaragua's external debt negotiations, he wished to clarify that the performance criterion was the completion of the review of the program in February 1995, which would take into account the financing issues of the program, namely, the progress that had been made in negotiations with Paris Club creditors as well as with non-Paris Club creditors, the staff representative from the Western Hemisphere Department explained. Over the medium term, Nicaragua would need substantial support from the donor community, but viability would be possible only with a substantial amount of debt reduction. In that regard, it should be noted that the effort that Nicaragua would make in terms of adjusting the external current account, excluding interest not paid, was significant: the external current account deficit was expected to move from 29 percent of GDP in 1993 to about 23 percent in 1997. There would also be a substantial improvement in the reserve position, which was already under way, from about 1.3 months of imports to almost 4 months of imports. In any event, the issue of the treatment to be given to the external debt was extremely important in Nicaragua's case.

Mr. Lvin observed that according to the staff report, one criterion for further disbursements was that "Nicaragua will not request disbursement of the second loan...if [it] has incurred any new external payments arrears, except arrears pending renegotiation." The staff had noted that the exclusion of arrears pending negotiations related primarily to commercial bank creditors and did not cover arrears to official bilateral creditors. Thus, his authorities understood the arrangement as clearly contemplating the conclusion of negotiations on the rescheduling of official debt, or substantial progress in those negotiations.

The staff representative from the Western Hemisphere Department stated that overdue payments on reschedulable obligations would not be considered arrears until negotiations with creditors were concluded. If an agreement was not reached by the date specified for the conclusion of bilateral agreements in the Paris Club agreed minutes, the staff would review the extent to which the failure to reach agreement depended on the efforts of the country, and a decision regarding further disbursements would have to be made in the light of those findings.

The staff representative from the Policy Development and Review Department remarked that throughout the process of negotiations with creditors, the staff would be reporting to the Board, and the Board would have an opportunity to determine whether the country was making its best efforts to resolve its outstanding debt.

Mr. Lvin observed that the reschedulability of obligations, which was subject to Fund assessment, was in itself a matter of progress in negotiations with creditors. It was up to both parties in the negotiations to establish what obligations were to be rescheduled. Therefore, in his authorities' view, progress in the negotiations should be clear and significant up to end-February 1995.

The staff representative from the Western Hemisphere Department said that it was true that the determination of the obligations to be rescheduled and the terms were a matter of bilateral negotiation. The criterion referred only to whether best efforts were being made by the debtor country to reach an agreement. That was the aspect that the Board would be taking into consideration when making a judgment on whether the program could proceed in the context of the review. The staff and management would, of course, be looking for substantial progress in that regard.

Mr. Blome stated that he understood that 80 percent of the public investment program was financed by foreign grants. According to his calculations based on Table 2 of the staff report, about 60 percent of the public investment program was financed by foreign grants.

The staff representative from the Western Hemisphere Department recalled that he had stated that 80 percent of the investment program was financed by foreign grants and loans, which were included below the line as part of the external financing of the program. While the loans would lead to some increase in the public deficit, they were, to a large extent, on concessional terms.

Mr. Jiménez de Lucio made the following statement:

Considerable progress has been made over the past three years in terms of macroeconomic stabilization and the introduction of the structural reforms required for fostering a sound market-based economy, pacifying the country, and restoring relations with the international financial community. The authorities deserve to be commended for their efforts and success to date. Nonetheless, much remains to be done before an environment conducive to strong private sector-led growth is fully in place, and international support continues to be critical to the success of the adjustment effort. In this regard, we welcome the 1994-1997 economic program prepared by the authorities, and their request for Fund support under the ESAF.

The policy framework paper clearly identifies the main tasks ahead. Moreover, we are in general agreement with the thrust of the staff appraisal. Therefore, we will only comment briefly on four topics: downsizing of the public sector, improvement of tax administration, clarification of property rights, and external financing requirements.

Nicaragua's public sector still absorbs an excessive proportion of available resources, thereby constraining private sector development. Priority must be given to the reduction of public employment and other defense-related expenditures, as well as to the divestiture of public entities.

Considering the pressures likely to be associated with the freezing of public sector wages and salaries over the next two years and the large demand for resources to meet social needs, expenditure restraint must be complemented by increased fiscal revenues. Both the enactment of appropriate tax legislation and regulations, and further improvements in tax administration, are essential for the success of the program. Thus, we support continued Fund technical assistance in this area.

Well-defined property rights are a prerequisite for private investment and growth. The authorities acknowledge the need to promptly resolve the issue of land ownership in Nicaragua, which relies heavily on agricultural exports. It is difficult to overstate the importance of satisfactorily addressing this matter. In this regard, the possibility of allocating part of the privatization proceeds to compensate former owners seems an option worth pursuing.

The staff has clearly demonstrated Nicaragua's need for exceptional financing from the international financial community. Even if the adjustment program is fully implemented, it would still not be successful without substantial support from international creditors and donors; however, we are confident that the proposed Fund arrangement will catalyze the necessary concessional financing. We support the proposed decisions.

Mr. Calderón made the following statement:

Nicaragua has come a long way since the days of 13,500 percent inflation during 1990. But the road has not been easy. As the staff report points out, military personnel were reduced from 98,000 in April 1990 to about 15,000; the number of civil government employees was reduced by 30,000, or about 25 percent of total; and the state-owned financial institutions reduced their personnel from 9,070 to 3,460 employees during the past three years. In the area of structural reform, Nicaragua established the Superintendency of Banks, freed interest rates, began the divestiture of about 350 public entities managed by the National Corporation of Public Enterprises, and lowered most import taxes.

The strong adjustment program has enabled the authorities to lower the fiscal deficit from 31 percent of GDP in 1990 to 10 percent in 1993. Moreover, average inflation for 1993 was 20.4 percent, and they expect to lower it to 7 percent by the end of 1994.

However, Nicaragua still faces grave problems. The worst, no doubt, is its external debt. The following data give a good idea of the magnitude of the problem: while exports are expected to rise to $291 million during 1994, the financial gap is $4,179 billion. That is nearly 14 times as much as exports.

Even if fiscal and credit restraint is maintained and structural reforms are intensified, the medium-term balance of payments prospects still looks grim. Under the optimistic assumption that exports will grow at an average rate of 11 percent, over the next six years, and that imports will increase at a 5 percent rate, Nicaragua would still have an external current account deficit of 11 percent of GDP by the year 2000. Moreover, it would face exceptional financing needs averaging $390 million a year for the period 1996-2000.

As we have seen, Nicaragua has carried out a strong adjustment program. Nevertheless, it still needs to intensify its structural reforms. But, even if it accomplishes all the macroeconomic and structural adjustment policies for the years 1994-1997, it will not achieve external viability without a substantial debt reduction.

The staff's opening remarks provided some encouraging news: the Paris Club program anticipates a rescheduling on enhanced concessional terms. In addition, creditors are expected to provide financial assistance, while non-Paris Club officials are expected to opt for substantial debt forgiveness.

We hope that these prospects materialize and, therefore, urge Paris Club creditors to reschedule Nicaragua's debt on terms at least equivalent to those granted under the 1991 agreement, and non-Paris Club creditors to concede to terms at least as favorable as those granted by Argentina, Mexico, Venezuela, Colombia, and other Latin American countries.

We agree with the staff that the Government has demonstrated its commitment to a strong adjustment program, and therefore support Nicaragua's request for an arrangement under the ESAF.

Mr. Hamilius made the following statement:

We note with satisfaction that the Nicaraguan authorities are taking serious measures to restore general confidence in their economic prospects.

Despite these measures, however, Nicaragua's macroeconomic fundamentals remain fragile and are directly dependent on foreign assistance. Of particular concern is the persistence of strong distortions and structural rigidities as a result of civil conflict and political difficulties. It is absolutely essential to launch broad policies as soon as possible leading eventually to sustainable growth.

The program is ambitious, perhaps even overambitious in light of Nicaragua's present potential.

The expenditure side of the proposed fiscal program notably involves a reduction in the number of public sector employees and a freeze on public sector wages, complementing a whole range of tax measures already taken at the end of last year and the beginning of this one. Because this follows an earlier reduction, in the first years of the decade, in the numbers of military personnel and government employees, it will be important to both macroeconomic and social stability for the Government to strengthen its social programs and broaden its poverty alleviation efforts. We urge the Government to supplement its efforts to downsize the public sector by increasing the efficiency of its operations.

A precondition to a revival of growth in Nicaragua will be a quick resolution of the issue of property rights. The staff is entirely correct in saying that it is "essential to establish the basis for private investment and sustained economic growth." Like Mr. Blome, we hope the Government will have the fortitude to follow through with the program outlined in its letter of intent even at the risk of reopening unhealed wounds. The property issue is especially important in the agricultural sector, which accounts for 25 percent of GDP. However, we have doubts about the attractiveness of the 20-year bonds being considered as a way of financing the compensation payments.

The favorable outcome of the proposed program will greatly depend on how successfully the authorities are able to handle their debt problems and obtain further financial support. The debt problem is the key question in Nicaragua: the country's present critical external situation will certainly not encourage foreign private investment; hence, the importance of external support.

We urge the Government to conclude all its bilateral agreements as rapidly as possible, and to find comprehensive solutions with non-Paris Club creditors. Considering the difficulties the authorities are encountering in this area, we were surprised to note that they are still incurring additional nonconcessional credit obligations. It would seem that a more prudent policy is needed.

We support the proposed decision.

Mr. Golriz made the following statement:

The excellent staff papers provide a comprehensive picture of the pace and magnitude of the efforts recently taken by the authorities to stabilize their economy and remove macroeconomic imbalances. The program covering 1994-97 to be supported by an ESAF arrangement also appears to be a sound and viable policy framework. As we are in general agreement with the thrust of the staff appraisal and policy recommendation, our comments are limited to a few areas of interest.

While substantial progress has been made in the area of trade and financial liberalization, for which the Nicaraguan authorities deserve commendation, one wonders why the supply has been slow to respond to policy measures. We note that GDP declined in 1993 after a small recovery in the year, and for the last three years GDP has grown less than 1 percent. With the population growth of more than 3 percent, even the 1 percent to 1.5 percent growth of per capita income planned for 1994 seems difficult to achieve. The staff report implies that the supply rigidity seems to be more a reflection of the lack of confidence in the economy than the policy stance. The evidence, in at least two areas, seems to support this view. First, credit to the private sector fell in 1993 by more than 3 percent, and demand for money declined by almost 10 percent. Second, a shortfall of external assistance can imply donors' reservation. As regards the latter, an analysis of the use of the external assistance reveals that only a small percentage of the resources provided by the international community went to specific projects, and the rest was devoted to servicing the country's foreign debt. The staff anticipates that the amount of aid will further decrease in 1994-95.

In such difficult circumstances, the authorities will need to reassure both the private sector and external donors of their commitment to adjustment, and translate their assurance into action. More specifically, they will need to provide a legal framework that would clearly define the restitution process and guarantee that the property rights protection will be the basis for increased private sector involvement in the economy.

Concerns may also be raised by the relatively lengthy process of privatization. It is noted that presently four different agencies are involved in the privatization, and this could discourage a fast and forceful process. A more simple approach involving less formalities would not only be cost effective but it is to be hoped would convince the private sector of the authorities' resolve to downsize the public sector. Staff comments on other approaches, such as direct coupon or voucher issuance, would be appreciated.

We are encouraged to note that the authorities are well aware of the risks involved in the easing of the fiscal stance. The scope to generate more revenue is limited owing to Nicaragua's narrow production base, consistent shortfalls in real sector performance, and unfavorable world market conditions for its principal exports. On the expenditure side, however, efforts should be continued to further decrease the burden on the budget. We are pleased that in addition to previous reductions in the number of public sector employees, a further reduction of 13 percent has been envisaged in the program for 1994-96.

As to monetary and exchange rate policies, we are in agreement with the measures taken to restrain inflation and restore balance of payments viability. We are particularly impressed by the interest rate and credit policies. As is evident from the policy framework paper, interest rates are mainly free of controls and some credit operations of the Central Bank that still take place at below market rates are to be halted as the ESAF arrangement becomes operative. However, we would like to emphasize on the need for strengthening the banking supervision capacity of the Central Bank as new banks are being established and intermediation is being liberalized. The exchange rate policy also seems consistent with the balance of payments objectives and provides a mainstay for the price stability. The authorities are advised to keep the exchange rate under close review and respond properly to the developments that can frustrate competitiveness.

As the spread between the official and parallel rates is narrow, the authorities are encouraged to consider moving toward a unified exchange rate.

With an external debt equal to more than five times GDP, Nicaragua will need to attach special importance to its financing needs. The country is burdened with heavy repayment obligations and the need to eliminate external payments arrears. Mr. Marino's statement, as well as the staff opening remarks, indicates that some encouraging progress is under way. Agreements between Nicaragua and certain non-Paris Club creditors have been concluded, and a Paris Club meeting has been scheduled for September. There is no doubt that the success of the stabilization efforts and resumption of sustained growth will depend, to a large extent, on the level of support from the creditors for a generous debt relief, as well as support from the international financial community and donors.

With social spending at 11 percent of GDP, Nicaragua outpaces many countries of its rank. Moreover, in allocating social resources there appear to be some troubling inefficiencies. In addition to weak institutional capacity in the line ministries, poorly chosen priority such as excessive emphasis on higher education when basic education is not available to everyone is a source of concern. We urge the authorities to redefine their priorities for social spending and formulate a safety net scheme targeted at protecting the neediest segment of the population.

With these remarks we support the proposed decisions.

Mr. Bergo made the following statement:

I would like to thank the staff for a thorough analysis of the Nicaraguan economy, with which I broadly concur. I would also commend the authorities for having decisively initiated the reform toward a market economy.

However, Nicaragua starts its reform from an extremely difficult position. The external debt and the external current account deficit are large, and the difficult external outlook will prevail for many years; thus, the proposed increase in Fund exposure carries considerable risk. The fact is that Nicaragua will not be able to generate sufficient domestic savings for many years to come, and how to fill the financing gaps will remain high on the authorities agenda for the foreseeable future. The immediate financing needs and rescheduling requirements are indeed staggering.

The international financial community will therefore have to play a crucial role in economic reconstruction and transition in

Nicaragua. And as we have heard from Mr. Marino and the staff today, that community has indeed shown goodwill and has indicated its support at the recent consultative group meeting.

To ensure that the necessary external financing will continue in the future, Nicaragua must make every effort to preserve the confidence of donors and creditors. One way to ensure that would be to treat the medium-term program, envisaged in the letter of intent, as a minimum target. This is important because the projected external balance during the first program year is primarily based on the assumption that the prices of certain commodities will develop favorably. However, we all know how volatile these prices can be. Thus, I would have liked to see some contingency plans in the event that the external balance performs worse than anticipated in the program.

Against this background, certain recent developments give rise to some concern. The arrears situation, the postponement of some of the planned revenue measures, and the Government's intention to proceed with its trade liberalization program at a more gradual pace than envisaged are worrisome. Even if these deviations may not be all that important and despite many positive developments, I am afraid that Nicaragua's still fragile credibility cannot afford many such deviations.

I am particularly concerned about the poor performance of the public sector balance. The combined public sector deficit seems to have become fixed at the level of 10 percent of GDP. The recent additional fiscal measures have been insufficient to offset earlier slippages. I would urge the authorities to closely monitor these developments, and when needed, promptly take strong measures to keep to the programmed stance on the public finances. A financially sound public sector is one of the most important prerequisites for balanced and sustainable growth. Furthermore, the strengthening of public savings in this way can also be the first step to strengthening domestic savings, which is necessary for Nicaragua to repay its debt in the future.

Even though Nicaragua has to begin its restructuring work in an extremely difficult situation, the authorities should aim at decisive, rapid structural change combined with prudent macroeconomic policies. In the medium term, this is clearly the least costly way to a market economy, as some countries in my constituency are in the process of proving. I am pleased to note that the institutional basis for conducting a consistent reform policy appears to have improved, as the National Assembly and the Government recently agreed on better mutual dialogue and cooperation after a period of numerous open and not so open conflicts. The political risk in Nicaragua nevertheless remains considerable.

I believe that, if fully implemented, this program is an acceptable start to the process of transforming the economy and that it could provide the foundation for sustainable growth. Hence, I can support Nicaragua's request for a three-year arrangement under the ESAF and the first annual arrangement, but I would hope for an acceleration of the process toward external viability in the subsequent arrangements.

Ms. Petana made the following statement:

Since the implementation of their stand-by program with the Fund, Nicaragua has achieved considerable progress toward macroeconomic consolidation and structural reforms. Despite disappointing results in 1993 owing to external shocks and some policy slippages, the inflation rate was substantially reduced and the fiscal situation improved since 1990. Nevertheless, its weak and vulnerable external position makes the country heavily dependent on external financing. Even with a favorable scenario, debt relief and rescheduling are necessary to cover the financing needs of the balance of payments over the next few years.

In order to achieve a sustainable noninflationary growth and improve the external viability of the country, a continued macroeconomic consolidation effort and structural adjustment measures are necessary. The Government's program contemplates reforms in the areas of property rights, privatization, the financial sector, labor market, and trade. These measures aim at promoting investment, increasing the participation of the private sector in economic activity, and removing existent distortions in the economy thereby enhancing competitive growth, contributing to increased exports and reducing the unemployment rate, which amounted to almost 22 percent in 1993.

With the aim of ensuring exchange rate stabilization consistent with the objective of promoting export growth, the Government decided to increase from 5 percent to 12 percent, as of November 1993, the annual rate of depreciation of the crawling peg of their currency to the U.S. dollar.

The decision to peg the exchange rate has several consequences in terms of monetary and fiscal policies, and my comments will focus on these areas. Concerning monetary policy, the crawling peg implies that the authorities must promote the necessary measures to keep the inflation rate within the levels permitted by the exchange rate crawl in order to avoid facing the deterioration of export competitiveness. With respect to the fiscal side, restraint is required because policies must be compatible with the achievement of the target for inflation. The fact that seignorage can no longer be used to finance the increased deficit puts a limitation on its size. Therefore, even though the depreciation of the currency might initially contribute to an upward pressure on prices, it also enhances the urgency of preventing inflationary pressures, and the decision to peg the currency is a sign of the authorities' commitment to this goal.

Concerning the public sector, the program envisages an increase in public savings--taking into account net interest paid--of 2.3 percent of GDP. Among the measures being implemented toward fiscal consolidation, it is suggested that the freeze on public sector wages and salaries be maintained. Besides its impact on fiscal expenditures, a prudent wage policy contributes to controlling inflation and improving the competitiveness of production.

Despite existing distortions in the economy, monetary and credit policies envisaged in the program are broadly consistent with the objectives of growth and inflation. The implementation of open market operations in 1995, enabling the Central Bank to absorb excessive liquidity, will facilitate the control of monetary aggregates. In addition, the decision to eliminate preferential bank financing by the public sector will make more credit available to the private sector. However, despite the intention to liberalize interest rates, a portion of the credit operations of the Central Bank will still take place at below market rates, according to the authorities' letter of intent. As the rate established by the market enables a better allocation of financial resources, the authorities should be encouraged to eliminate this restriction.

The existence of high spreads between deposit and loan interest rates--11-12 percent for 30-day deposits and 20-23 percent for loans--is evidence of the inefficiency of the banking sector in promoting financial intermediation. This inefficiency, which according to the staff is due to the high operating costs of major public banks, is being dealt with by measures aimed at reducing such costs and improving the loan recovery of the two major state-owned banks. The implementation of these measures will have a favorable impact on the spread between loan and deposit rates, and therefore will contribute to reducing the costs of financial intermediation.

As pointed out in the staff report, the difficult external outlook for Nicaragua represents an exposure risk for the Fund. If exports and imports do not evolve as planned, an additional financial gap might appear. The program does not have a margin for further slippages, and in order to obtain the needed support from the international community the authorities must fully comply with its implementation. With these remarks, I support the proposed decisions.

Mr. Rainford observed that the divestment of public enterprises was a complex and difficult matter, as experience had shown in many countries, particularly when a large number of enterprises was involved. In Nicaragua's circumstances, the ambitiousness of the divestment program was especially striking. He noted that one of the structural benchmarks required a certain number of enterprises to be divested by April 1994; he wondered whether that target had been met. He was concerned that it would not be possible to meet the ambitious target for 1994. That was not to say that public enterprise divestment was not urgent, but rather, that a balance had to be struck between the urgency of the task and realism about how much could be done.

The staff representative from the Western Hemisphere Department remarked that data for the first few months of 1994 showed that there had been a significant increase in exports for two reasons: an increase in coffee prices and a significant increase in export volumes of coffee, beef, and nontraditional exports. At the same time, there had been a reduction in imports, particularly of consumer goods, as a result of the tightening of credit policy in the first few months of the year.

As to the divestiture of public enterprises, the benchmarks had been established in terms of offering for sale, offering for lease, or closing down the enterprises, the staff representative from the Western Hemisphere Department stated. In some cases, the process of divestiture could take more time, but the benchmark for end-May 1994 had been achieved; the authorities had already offered for sale or closed down the enterprises indicated in the staff report.

Mr. Marino said that he wished to thank Executive Directors for their valuable comments and policy guidance, and for their support of Nicaragua's request for an ESAF arrangement. He also wished to thank the staff for the comprehensive answers to Directors' questions and for the update on recent economic developments in Nicaragua. In addition, he wished to join Ms. Lissakers in extending his great appreciation to the Managing Director for his helpful role in unlocking the negotiations and helping the Nicaraguan authorities garner sufficient support for their program in support of the ESAF arrangement.

When analyzing the case of Nicaragua, it had to be realized that the country was undertaking transformations in three main areas: from a war-torn country to a pacified country, from an authoritarian system to a democratic administration, and from a centralized economy to a market economy, Mr. Marino continued. It must also be recognized that transformation usually took more time than anticipated.

Nicaragua has progressed substantially in resolving its political and economic problems, and in establishing the necessary conditions for sustained economic growth, Mr. Marino stated. Nevertheless, as many Directors had pointed out, and as his authorities recognized, much remained to be accomplished. Serious challenges still lay ahead, and many conflicts had to be overcome, mainly through the efforts of the Nicaraguan people. However, the tasks ahead could not be achieved without the generous assistance of the international community and the medium-term framework that the ESAF arrangement provided.

With regard to the issue of properties in conflict and property rights, the Office of Compensation and Quantification had been created, and a bond compensation system had been introduced, Mr. Marino commented. As of end-February 1994, about $105 million in compensation bonds had been issued, of which 22.8 percent had been redeemed.

Many of the difficult political and institutional issues had been addressed, Mr. Marino observed. Currently, the National Assembly of the Republic was functioning normally. A comptroller general, who was accepted by all political groups in Nicaragua, had been appointed; the Supreme Court had been reorganized, and only two judges from the previous administration remained.

In the economic arena three significant objectives had been reached: the elimination of hyperinflation, the rapid transition from a centrally planned economy to a market-oriented economy, and substantial advances in structural reforms so as to reduce the role of the state in the economy, Mr. Marino stated. The results of the first four months of 1994 were encouraging. Nicaragua had stabilized its economy; now it needed to grow. To that end, investment in physical and human capital were of the utmost importance. He was confident that the actions taken would increase the growth potential of Nicaragua.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They commended the authorities for their success in keeping inflation at a low level despite the difficult political situation, but they expressed concern about the marked deterioration in the foreign reserve position in 1993 and the sluggishness of economic activity. Directors noted that fiscal performance had been weaker than originally envisaged for 1993 and that the momentum of structural reform had slowed.

In this context, Directors welcomed the adoption by the authorities of a program for 1994-97 to be supported by arrangements under the ESAF, which aims to consolidate the gains that have been achieved in the area of macroeconomic stabilization and to intensify structural reforms. They commended the authorities for their considerable efforts in putting the program together, and added that it would put to the test the strength and perseverance of the Government.

Despite the sharp cuts in the civil service, demobilization, and the reduction of military outlays, the public sector remains large and inefficient, and fiscal policy was, therefore, appropriately the centerpiece of the Government's program. The revenue and expenditure measures introduced since November 1993 were welcomed. Directors also encouraged the authorities to proceed as planned with periodic adjustments of public sector prices; to strengthen tax and customs administration; and to maintain firm control over the current outlays of the Central Government and the operating position of the public utilities and the social security system. In particular, Directors emphasized the need to maintain the wage freeze for public sector workers, to proceed vigorously with the program to reduce employment in the public sector, and to continue reducing military expenditure.

In the area of credit policy, the steps taken by the authorities to eliminate net central bank financing of the state-owned banks and to channel increasing amounts of credit through the private banks were noted. In addition, recent measures to reduce the losses of the Central Bank and align its interest rates with the markets were welcomed. Directors urged the authorities to proceed without delay with the planned restructuring of the two largest state-owned banks.

Directors welcomed the recent improvement in external competitiveness, which appeared to be having a positive effect on exports, as well as the authorities' commitment to keep exchange rate policy under close review to ensure that the balance of payments objectives of the program are attained.

In addition to the reforms of the financial and exchange systems, Directors attached crucial importance to the decisive implementation of structural measures envisaged under the program in the areas of property rights, privatization, the labor market, and the trade regime. In particular, Directors urged the authorities to accelerate the resolution of the property rights issue, which would facilitate private sector investment and production, and to move expeditiously with the partial privatization of the state-owned telecommunications company (TELCOR) and other public companies, which would increase efficiency and provide resources to redeem public debts.

Directors observed that Nicaragua's external situation remained fragile, and that achievement of external viability required the continued pursuit of strong adjustment policies, together with substantial debt relief from official and commercial creditors, as well as further external financing on highly concessional terms for a number of years. Directors noted that financing under the program would remain tight and that the authorities should give consideration to additional adjustment measures, all the more so since it was observed that, on present prospects, there was not much prospect for improvement in external viability during the period of the program under the ESAF.

Directors underscored the importance of concluding the bilateral agreements still pending under the 1991 Paris Club rescheduling, and also concluding new rescheduling agreements with Paris Club and non-Paris Club official bilateral creditors. In this regard, Nicaragua's plan to intensify discussions with the Russian Federation in July and its request for a Paris Club rescheduling in September were regarded as positive steps. Directors also noted the importance of resolving the issue of Nicaragua's debt with commercial bank creditors, which would require concessional assistance from donors in addition to the resources already committed by the International Development Association through its debt-reduction facility.

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

The Executive Board took the following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Nicaragua's exchange measures subject to Article VIII, Sections 2(a) and 3, in the light of the 1994 Article IV consultation with Nicaragua conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Nicaragua maintains restrictions on the making of payments and transfers for current international transactions as evidenced by certain external payments arrears, and on payments for invisibles, subject to Fund approval under Article VIII, Section 2(a), and engages in a multiple currency practice arising from the operation of private exchange houses, subject to Fund approval under Article VIII, Section 3. The Fund approves the retention by Nicaragua of the exchange restrictions on payments for invisibles until end-February 1995 or completion of the review under the first annual arrangement under the enhanced structural adjustment facility, whichever is earlier; and the restrictions on payments for private debts and the multiple currency practice until end-June 1995.

Decision No. 10721-(94/57), adopted
June 24, 1994

Enhanced Structural Adjustment Arrangement

1. The Government of Nicaragua has requested a three-year arrangement under the enhanced structural adjustment facility, and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for Nicaragua set forth in EBD/94/93).

3. The Fund approves the arrangements set forth in EBS/94/116, Supplement 1.

Decision No. 10722-(94/57), adopted
June 24, 1994

3. GHANA - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Ghana (SM/94/133, 5/31/94). They also had before them a statistical annex (SM/94/140, 6/7/94).

Mr. Mirakhor made the following statement:

The staff has produced a clear, fair, and balanced assessment of economic developments in Ghana in 1993 and the prospects for 1994 and the medium term. As always, my Ghanaian authorities are appreciative of the staff's hard work and agree with much of the analysis contained in the report. They are also giving most serious consideration to the staff's policy recommendations and look forward to the Board discussion, and Directors' remarks and policy guidance.

Directors will recall that last year the authorities set for themselves the ambitious task of reversing, within a single year, the financial imbalances that had occurred in the wake of the disruption associated with the transition to democratic constitutional government and the severe terms of trade shock. Their determination to do so was based on the belief that, despite the daunting policy requirements of such an abrupt adjustment, the early restoration of stable macroeconomic conditions was essential to re-establishing Ghana's record of policy implementation and strengthening the foundations for external viability and accelerated growth.

However, as the staff report notes, 1993 produced mixed results. On the positive side, strong output growth in the agriculture and mining sectors helped raise GDP growth to 5 percent, and significant progress was made in the implementation of structural and institutional reforms. In the external area, the authorities took a number of steps to further liberalize the exchange and trade system, and early this year accepted the obligations of Article VIII, an action that provides a strong signal to domestic and external investors of the authorities' commitment to achieving their external objectives through the continued implementation of sound economic policies.

Other developments were less reassuring, and performance generally has fallen short of expectations. While an important beginning was made toward reversing the deterioration in the fiscal position, only about one half of the intended adjustment was possible owing to revenue shortfalls and expenditure overruns. In the case of revenues, the authorities were unable to garner the necessary political consensus for another round of petroleum price increases--subsequently taken in the budget for 1994--following the substantial adjustment that had been effected in the previous year. However, intensified collection efforts and administrative improvements resulted in a 78 percent increase in revenues from income and property, while nontax revenues also increased sharply. There were also major expenditure overruns, although it should be recognized that more than one half of the excess in recurrent spending was caused by unanticipated factors, including contributions to the peacekeeping efforts of the Monitoring Group of the Economic Community of West African States (ECOMOG) and a short-term salary advance to civil servants. Furthermore, it is notable that the authorities stood firm in their efforts to contain the wage bill and keep development expenditures within budgeted cash limits.

The pressures emanating from the fiscal position proved too challenging for monetary policy. Despite active intervention, the Bank of Ghana could neither neutralize the impact of liquidity growth nor stem the pressure on the cedi. As a result, inflation rose to 28 percent, and the currency was devalued by 34 percent in terms of the U.S. dollar in 1993. Notwithstanding good export performance, there was a marked weakening of the external current account.

The staff says that the authorities' program for 1994--which has been set within a medium-term framework--is "realistic and feasible, and represents a balanced and well-designed strategy to deal with existing macroeconomic problems." My authorities can certainly agree with this assessment. In designing the program and assessing the feasibility of its implementation, it was important to avoid some of the pitfalls associated with implementing last year's adjustment effort, namely, reliance on a single, socially sensitive source of revenue. While sustained corrective action in the fiscal area remains the key to achieving macroeconomic stability, the revenue effort relies on a much broader package of measures that have already been adopted in the budget for 1994. The staff report provides a detailed account of these measures, and I can confine myself to highlighting a few points.

The staff has proposed an automatic retail-pricing formula for gasoline, which would prevent an erosion of tax revenue by making it more responsive to landed costs. My authorities are prepared to give careful consideration to this proposal. My authorities also agree, circumstances permitting, that all of the proceeds of the divestiture program, beyond the $110 million already assumed, should be applied to debt reduction--which will help the authorities' monetary objectives--or be used for the acquisition of foreign investments. The authorities remain committed to reducing further the civil service wage bill while protecting the pay relativities in favor of high-caliber managerial staff. Finally, the comprehensive preparatory work that has been undertaken this year should pave the way for the introduction of a value-added tax (VAT) by January 1995.

The actions in the fiscal area are to be complemented by a tight rein on broad money in line with the projected decline in inflation and a strengthening of the external position. The bulk of the adjustment necessary to return the current account to a more sustainable path is to be undertaken in 1994. This outcome will be helped by favorable price developments for cocoa and large volume increases for gold and timber exports, while import demand will be held in check by firm demand management and exchange rate policies. It is expected that the overall balance of payments will move into larger surplus in 1994, enabling Ghana to raise its gross foreign exchange reserves to more comfortable levels.

Ghana has done extremely well in implementing its structural reform agenda. The authorities intend to build on this momentum to create an environment that allows the private sector to play a leadership role. The enactment of the new investment code, which simplifies the regulatory framework for private investment and strengthens investment incentives, represents an important step in that direction. The Government also expects to make further significant progress toward implementing its divestiture program. Structural measures are also being taken to increase the efficiency of the public sector. These measures resulted from a public sector expenditure review and include steps to improve the management and transparency of public expenditures. As part of their social safety net program, the authorities have put in place budgetary measures intended to ease the costs of retrenchment in the public sector work force.

My authorities are confident that the adjustment effort in 1994 will be sufficient to bring economic performance back on course. In retrospect, the task of seeking a full and immediate return to stable macroeconomic conditions after the dislocation caused by the events of 1992 proved to be more challenging and onerous than had been anticipated--a task that was made all the more difficult by unfavorable exogenous factors. Despite the many setbacks, and political pressures to delay the adjustment effort further and ease the pain, my authorities have not lost sight of the vital importance of restoring macroeconomic stability and re-establishing their good track record. They recognize that it is only through sound policies and continuing policy reform that Ghana can unleash the energies and creativity of its people for accelerated growth and higher living standards.

Mr. Dorrington made the following statement:

When I look back at macroeconomic performance in 1993 in Ghana, I am reminded of the proverb that half a loaf is better than none. Certainly there was a marked improvement from the terrible year of 1992, but this fell well short of the authorities' intentions. We recognized a year ago that these plans were ambitious--perhaps with the benefit of hindsight they were overly ambitious--and the staff gives the clear impression that the plans for 1994 are more likely to be achieved than were those for 1993. I certainly hope so. Missing targets damages credibility, and even if the forecasts in Table 1 of the staff report are entirely accurate, it will not be until some time in 1995 that consumer price index inflation returns to its end-1992 level. Furthermore, the budget and current account balances will not return to their 1992 levels until 1996.

All of this underlines the importance of careful monitoring by the authorities and the staff, and the willingness to take timely remedial actions if necessary. In this context, I would be grateful for any indication the staff or Mr. Mirakhor can give of the probability of the quantitative benchmarks for end-June being achieved as well as the structural benchmarks. I would also appreciate any comments the staff or Mr. Mirakhor can make on the economic effects of ethnic clashes in the North, including effects on the budget, and on agricultural production and prices.

One area of particular uncertainty where close monitoring will be necessary is tax revenue; indeed, I wonder whether the forecasts are optimistic. Primarily this is because the authorities have a poor record on collection of sales tax and import duties. Also, taxes on international transactions are expected to rise by as much as 136 percent. I understand that a large part of this rise results from an increase in local currency terms of the export price of cocoa, which will not be reflected in producer prices until next year, thereby providing a boost to the profits of the Cocoa Board. Could the staff indicate whether, when this lag unwinds in 1995, revenue from this source will decline, and if so, to what extent?

In view of the problems with tax collection in the past, I have some difficulty with the staff's opposition to the system of presumptive prices for imports. If prices are set at reasonable levels and the system works, which seems to be the case, this seems to be a pragmatic second-best solution that can perform a useful role until the first-best option is available.

Another important source of revenue is privatization, and here I support the staff's advice to use the proceeds to reduce net external debt. I will have more to say about privatization later, when I talk about structural reforms.

In general there is little scope for spending cuts. Indeed, keeping to the target for the wage bill will not be easy, but is vital. While in a pedantic sense the target was achieved last year, this was accompanied by the granting of a salary advance, which might be construed as an increase in pay in 1993. Generally, the civil service suffers from inefficiency and low pay. I understand that the World Bank is advising on civil service reform, which is clearly needed and welcome.

I have two other points on expenditure. First, I noticed in Table 24 of the statistical annex that expenditure for so-called other purposes rose from zero in 1990 to about 0.7 percent of GDP in 1993. What does this spending relate to? Second, I was concerned about the arrears, particularly as the staff does not know how large they are. It is clear that expenditure on a commitments basis is not under tight control, whatever the position is on a cash basis. There clearly needs to be an improvement here.

The monetary program is tight and implies a substantial increase in velocity. The staff recognizes that this might not materialize and suggests that this could imply lower than expected inflation. But if the money targets can only be achieved by high real interest rates, then lower nominal GDP growth may be achieved at least in part by weaker activity. Excessively high real interest rates would also have implications for debt interest, and thus for the overall fiscal position and monetary growth. There is a danger of a vicious circle developing. In these circumstances some modification in the program might be appropriate. I raise this only as a risk; if it occurs it would be wise for the authorities to consult further with the staff. Meanwhile, there should be no wavering from the program. In any event, prevention is better than cure, and the stronger the fiscal position, the less likely it is that this problem will materialize.

On structural reforms, Ghana has much to be proud of, and the acceptance of Article VIII status is a welcome continuation of a good trend.

There has also been good progress on exchange rate liberalization, which does not seem to be matched by the freeing of domestic interest rates. The yields on government securities appear to be largely determined by the level of the central bank discount rate, and I urge the introduction of competitive bidding at auctions.

In the banking sector, the authorities have made impressive strides in liberalization. Banks are now much more competitive. Ghana seems to be following the model of Zimbabwe in its development of the financial sector. This favorable environment bodes well for the privatization of state-owned banks. The authorities would be wise to sell off these banks quickly in case increased competition makes them less attractive.

More generally, the sell-off of the Ashanti Goldfields seems to be going very well, but there is less evidence that privatization of the rest of the public sector is proceeding as quickly.

The statistical appendix includes data for 13 large parastatals. But for five of them, no data is as yet available for 1993, and for one of them no data is available for 1991 or 1992. And this may be only the tip of the iceberg. This raises four concerns. First, it surely demonstrates that many of the state-owned enterprises are not yet in a position to be privatized. Second, it must seriously inhibit the ability of the authorities to monitor performance in these institutions. Third, it inhibits macroeconomic monitoring generally. And fourth, the lack of transparency must tend to undermine confidence.

A related matter of concern is the fact that, according to Table 13 of the statistical appendix, private savings, which had ranged between 6 percent and 7 percent of GDP in each year from 1990 to 1992, fell to 2.3 percent in 1993. This figure, however, includes state enterprises. As we do not know how much of this decline is due to them, and how much is due to the private sector proper, it is difficult to infer the reason for the decline and, hence, the appropriate action. I would appreciate staff comment on this point.

The staff paper views the CFA franc devaluation as unlikely to have much impact on Ghana, and I am not so certain. Nevertheless, I believe that whatever the short-term consequences of the devaluation, a thriving regional economy will be unambiguously beneficial for Ghana in the long run. I do not want to pursue this issue further now, but I would be interested to know when the Board can expect to discuss the promised paper on the regional implications of the devaluation.

Mr. Obame made the following statement:

This chair is in broad agreement with the staff appraisal, and therefore I intend to be brief and confine my remarks mostly to the fiscal sector.

It is encouraging to note from the staff report that the Ghanaian authorities have implemented, with some degree of success, their stabilization program for 1993. This was put in place to correct the economic and financial imbalances that occurred in 1992, mostly as a result of a combination of several factors, including a difficult transition to democratic rule and continued adverse external price developments for Ghana's main exports. Indeed, boosted by good harvests for all major crops and strong output growth in the mining sector, real GDP rebounded to an estimated 5 percent in 1993, and significant progress was made in the implementation of structural and institutional reforms. However, performance in the fiscal and external sectors fell short of expectations as both budgetary and external current deficits widened and inflationary pressures intensified.

We welcome the authorities' renewed efforts to reinforce the adjustment process in 1994 through a macroeconomic policy package that has been designed to address the above-mentioned slippages. We particularly support the emphasis being placed on the fiscal area as a centerpiece of the stabilization effort. The fiscal measures to be implemented on both the revenue and expenditure sides appear to be comprehensive and should help achieve the budgetary objective for 1994. On the revenue side, we welcome the planned efforts to improve tax collection and strengthen tax administration. We also welcome the efforts made to streamline the tax system and the steps that have been taken to maintain the buoyancy of income and property taxes. As to the pricing of petroleum products, we find attractive the staff's suggestion to introduce an automatic retail pricing formula for gasoline. In our view, this suggestion should be considered by the authorities, and we are reassured by Mr. Mirakhor's statement that his authorities are prepared to do so. On the expenditure side, while the scope for substantial spending cuts might appear limited, it is important that every effort be made to contain increases in the wage bill. Also important is the need to continue reducing the operating costs of the Cocoa Board so as to enhance revenue receipts from cocoa. Similarly, we encourage the authorities to dismantle the monopoly of the Cocoa Board as suggested by the staff and allow licensed dealers to actively participate in the procurement and export of cocoa. In view of the sensitivity of this issue, perhaps the staff or Mr. Mirakhor could shed some light on the feasibility of that proposal and on whether the authorities are giving some thought to it. Regarding reform of the parastatal sector, we encourage the authorities to implement their public enterprise divestiture program and use, as a first-best option, the proceeds from the sale of public assets to reduce the nonconcessional debt.

We commend the authorities for the recent acceptance of the obligations under Article VIII and for their efforts aimed at maintaining a liberal exchange and trade regime. However, in view of the extreme vulnerability of the economy to changes in the world cocoa market, we encourage the authorities to broaden the scope of the country's export base. In this regard, we are pleased to note that the authorities are putting emphasis, through their newly adopted investment code, on promoting private sector activities.

Mr. Kannan made the following statement:

Despite the odds, Ghana's achievement is a commendable one. We welcome the commitment of the authorities to maintain the growth rate at 5 percent in 1994 and thereafter. It is encouraging to note that investment in the economy is picking up. A few areas remain sources of concern, and to facilitate the achievement of internal and external balances, the following require special attention.

To mitigate the ill effects of dependence on one crop, efforts to diversify the economy must be initiated. In this context, the authorities might consider providing vocational training. Furthermore, their efforts to encourage joint ventures is an ideal step.

I fully agree with Mr. Mirakhor that a turn around in the fiscal balance in a short span of one or two years is almost impossible, but the authorities could introduce necessary policy actions in the early stage to speed up the recovery. In this context, containment of wages and the introduction of a suitable tax system assume more importance.

I agree with the staff on the urgent need to introduce an automatic retail pricing formula for petroleum products. However, in the face of falling oil prices, it is not clear to what extent the Government can increase excise duties on petroleum products. Attempts might be made to develop a system that would allow automatic pass-through of the impact of foreign prices. There is also an urgent need to absorb the excess liquidity in the system. While we appreciate the efforts made by the Bank of Ghana to strengthen open market operations, the increase in the liquidity ratio by 15 percentage points and the level of the discount rate of 91 day-treasury bills--at 32 percent--are cause for concern. These are indications of the wide scope for improving both the banking system and the transmission channels of the interest rate mechanism. Such high rates will also pose problems in domestic debt management. Hence, before strengthening open market operations, the interest rate mechanism should be strengthened and excess liquidity sterilized on a sustainable basis.

The weak role of the interest rate mechanism is further reinforced by a low savings rate. Ghana is one of the few countries with a low rate of savings as well as wide fluctuations. In such an economy, the banking system has to assume more responsibility in improving domestic savings. The high proportion of nonperforming loans indicates the need to intensify banking supervision and control; otherwise, this will lead to erosion of confidence in the banking system. The Bank of Ghana should therefore intensify steps in this direction.

We recognize the importance of reducing the current account deficit, but it is not clear how import volumes, which in the last five to six years never exhibited a decline, could decline by 5.3 percent in 1994 compared with an increase of 17.9 percent in 1993.

In the present situation, the economy could not fully benefit from currency depreciation. While the cedi depreciated by 17.2 percent in 1993, the current account deficit increased to 9.4 percent of GDP as import values increased by 18.6 percent. Even after adjusting for volume increases, the exchange rate effect is pronounced. The authorities should exercise the utmost caution in effecting currency depreciation as this is not an ideal solution to the current account deficit. On the contrary, in view of the import structure, this may add considerably to domestic inflation.

I would appreciate the staff comment on the method by which the Bank of Ghana acquires foreign exchange. While the net foreign assets of the Bank of Ghana declined much more than envisaged under the program, those of commercial banks increased, indicating that a closer examination might be of interest.

Mr. Autheman made the following statement:

I share the staff's view that the authorities' program is realistic and feasible, and represents a balanced and well-designed strategy to deal with the existing macroeconomic problems. I agree with Mr. Mirakhor's and Mr. Newman's assessment that since 1992's slippages, the situation has substantially improved even if there remains a major risk.

If you allow me, I would like to deal with this topic in an unusual way. I had the pleasure, along with our colleague Mr. Evans, and a few of our colleagues in the World Bank, to visit

Ghana last month, and the extent of the structural reform and adjustment effort was quite obvious. At the end of our visit, I was surprised by the points raised by the President. He was concerned about the depreciation of the cedi and about the impact on real incomes of the high level of inflation. I would not have dared raise the issue, but I have reflected upon it and wonder whether there is a missing dimension in our policy advice to a country like Ghana.

Ghana has an outstanding track record of adjustment, which from time to time it finds difficult to maintain. We act under the presumption that what happened during the general election in 1992 will not happen again, but we are not so sure because inflation remains high and confidence in the currency remains low. The recent wage settlement--20 percent--is consistent with a forecast of inflation declining to 15 percent. It could be consistent with a forecast of inflation rising to 25 or 30 percent. I see a benefit throughout the early stages of the adjustment process to the policy of keeping the exchange rate fully flexible in order to maintain the external competitiveness of Ghana and to pay for eventual mistakes. I see a benefit to policy focusing on fiscal adjustment and current account balance, that is, a sustainable deficit. However, at some point, if nothing is done to reduce the prospect of inflation, or give confidence to the labor force that the value of wages and income will be better maintained in the future, how can we rely on a stable adjustment process? How can we prevent the risk of a further rundown of the currency and a more difficult social situation leading to a dramatic rise in wages?

This year may be the year of dramatic revisions in Africa. It could be useful for those who provide advice to Ghana to be ready to revisit the standard advice on exchange rate policy and monetary policy that was given to Ghana for many years, that is, to use this policy as a variable of adjustment.

I do not consider the present stance of monetary policy sustainable. Short-term interest rates of 30 percent imply inflation higher than 15 percent, if we believe that the rate of growth will remain positive. I was surprised by the configuration of reserve requirements and the overall reserve requirement rate of 57 percent. All of this seems to mean that there is a major credibility gap in monetary policy and that there is a major difficulty in implementation. I understand that it is easier to concentrate all of our efforts on the primary objectives of fiscal balance and foreign sector competitiveness, but I wonder whether it is not time to be more ambitious in Ghana and to address the concerns raised by President Rawlings.

On privatization, I agree that there is a case for using receipts to reduce debt, but why not external debt? Like Mr. Newman, I could not support the idea of building external assets. The investment shortage in Ghana remains high enough to consider it a priority to invest in the country.

On the evolution of growth--perhaps more an issue for the World Bank than for the Fund, but it should be of concern to our institution as well--growth in Ghana comes from the service sector, and the share of the service sector in the economy has risen from 41 percent in 1988 to 46 percent in 1993, mainly owing to increases in the share of wholesale and retail trade, which rose from 12.6 percent in 1988 to 15.9 percent in 1993. Perhaps growth is natural enough in Ghana for such a pickup in the share of the service sector, but simultaneously, the share of the agricultural sector has fallen from 47.4 percent in 1988 to 41.6 percent in 1993. In fact, all of the components of the economy are growing except agriculture. This means that either part of the real growth is artificial, or there are major investment or structural handicaps to stronger growth of agriculture. The example of the cocoa industry mentioned by previous speakers appears obvious, but we tend sometimes to identify structural reform with aristocratic issues, like privatization. I agree that selling back a gold mine is much more chic than reforming agriculture, but in a country like Ghana, sustainable growth cannot be achieved without growth in agriculture. I would appreciate seeing this issue addressed in greater depth.

Mr. Mirakhor said that he was impressed by the insight that Mr. Autheman had gained from one trip to Ghana. He believed that it was useful for Executive Directors to visit member countries outside their own constituencies to see exactly what was going on, how hard the staff worked in the field, and how difficult it was for countries to implement adjustment policies.

On previous occasions, he and Mr. Geethakrishnan had raised the issue of reviewing some of the Fund's policy prescriptions for dealing with the problems of growth and employment in developing countries, Mr. Mirakhor recalled. Mr. Autheman appeared to be indirectly addressing that issue. In doing so, he had done a great service both to Ghana and to the Board.

Mr. Newman made the following statement:

Ghana's recent policy slippages are particularly notable because of the contrast with the country's steady record of solid financial performance and rising output over the past decade. Ghana has established for itself a standard of performance that has not been met over the last two years--largely because of self-inflicted policy missteps. While we all understand election-related pressures, the lingering effects of the 1992 civil service wage "pinata" highlight the longer-term costs of actions taken for short-term gains. The real economy has shown better than expected resilience, but two years of underperformance on the policy side has meant that 1994 targets for key indicators, such as inflation and national savings, will still fall short of 1991 levels. Regaining the momentum of progress on stabilization is essential for 1994.

To be sure, Ghana remains a bright spot on the continent. Strong performance under the previous ESAF arrangement saw a substantial drop in inflation; improved fiscal performance; reduced government intervention in the economy; an improved balance of payments, including access to international capital markets; and steady GDP growth. As a result, per capita income has continued to increase despite the high population growth rate. Moreover, progress on structural reforms continues to be encouraging. We note the continued liberalization of the trade and exchange regime, including Ghana's acceptance of Article VIII obligations; investment reforms; and accelerated action on privatization. In the wake of the successful first tranche sale of holdings in the Ashanti Goldfields, the preparation for sale of some other big-ticket enterprises is particularly encouraging.

Recent fiscal and monetary policy shortfalls, however, are a source of concern and have contributed to Ghana's subpar external performance. Debt and debt-service ratios have turned upward sharply. A substantial improvement in the external position is expected for this year--and subsequent years--but will depend importantly on a correction in underlying policies.

On the fiscal side, the emphasis in 1994 is on boosting revenues. We have a few comments on the revenue measures discussed but would make the broader observation that spending as a share of GDP has been creeping upward--giving added impetus to initiatives to improve expenditure management practices and civil service restructuring. Using privatization receipts to retire and prepay domestic and external public debt should reduce interest costs, which have increased substantially. Accelerated privatization efforts in turn highlight the need to ensure that adequate resources are freed up for private sector investment: a "weather-eye" must be kept on the tax burden.

We understand that the recently granted 20 percent wage hike for the civil service is incorporated into this year's budget. It is also our understanding that last year's salary advance will be deducted from salaries this year, reducing the impact of the wage increase somewhat. Two general concerns emerge regarding the wage increase. First, recognizing that there was no increase last year--after the huge jump in 1992--and that unions were asking for larger raises, is the signaling effect of this action likely to help or hinder efforts to meet the 15 percent inflation target for the year? Second, what is being done to retain skilled personnel? The across-the-board nature of the increase does not appear to advance this goal, which would seem to call for a more differentiated adjustment in wages.

As to revenue measures, the streamlining of customs duties is a reasonable enough objective, although we note that the effect is to increase average tariffs, which is at odds with the general liberalizing trend in the economy. We recognize the problem of underinvoicing, but view the application of a "minimum presumptive prices" as a second-best solution that we would hope to see improved upon.

We agree with the staff on the need for better, more automatic pass-through of the import costs of petroleum, particularly in view of the more flexible exchange rate stance dictated by balance of payments objectives. Deregulation of petroleum prices could in turn serve as a precursor to a broader deregulation of petroleum distribution. We would encourage the authorities to pursue a more comprehensive liberalization of this sector.

Although cocoa revenues are expected to jump this year, Cocoa Board expenditures have exceeded projections in each of the past two budget cycles, which raises a number of fiscal and structural issues. Clearly, greater vigilance is required to control spending. In this regard, we are pleased to see severance packages for work force downsizing in the budget. The track record of expenditure control is poor, however, and a more fundamental change in the Cocoa Board's role is overdue in any event. We fully agree with the staff that removing the Board's export monopoly ought to be a near-term policy goal. More extensive private sector competition would enhance efficiency and presumably boost rural income as world prices are passed through. We would be interested in the authorities' intentions--including timetables for action--in this regard.

We were interested in the discussion regarding the disposition of divestment proceeds in excess of the budgeted $110 million, which accounts for the budget surplus and will serve to retire domestic debt, the stock of which is already low as a share of GDP. It was suggested that excess proceeds should be invested overseas or used to prepay nonconcessional foreign debt. A number of cash and debt-management considerations are at play here, but there appear to be some strong working presumptions in favor of prepayment. Interest payments on nonconcessional foreign debt are presumably at LIBOR plus some not insignificant risk premium, so surplus funds would need to earn a return in excess of this rate to make investment a more profitable proposition than prepayment--depending, of course, on prepayment costs. Considering that prudence dictates investment in low-risk liquid assets, the prospect for such a positive spread is likely to be remote. This consideration--with its clear fiscal implications--as well as the advantages to creditworthiness of reversing the recent surge in external debt levels, favor prepayment, to the extent feasible. Authorities should not hesitate to seek outside advice on these issues.

We understand that the staff's projections for future budgets--that is, 1995 and 1996--do not include privatization receipts. We would urge authorities to follow suit and not include such receipts in above-the-line revenue calculations--where they might inappropriately be seen as a funding source for recurring expenses.

The Bank of Ghana was late in reacting to the expansion in bank liquidity last year, and we trust that a more vigilant and gradual approach this year will help prevent any potential surges in credit and pre-empt possible jumps in inflationary expectations. We were surprised to learn that some of last year's overrun was accounted for by Bank of Ghana lending to the national petroleum company. The need for lending was apparently due in part to inadequate pass-through of gas prices, a problem noted earlier. The availability of such lending through the central bank is an additional problem. Can any assurances be given that this credit line will not be reopened in the future?

Despite recent slippages, the staff is generally optimistic regarding Ghana's external prospects, and we can share in this assessment. Debt levels have risen recently, but the maturity profile tends toward long-term obligations. Continued aid and credit flows appear more than sufficient to finance current account shortfalls, although the key assumption is that appropriate demand-management policies will be pursued. This assumption needs to be backed up with action. Strong policy performance this year should be seen as a necessary reassertion of the authorities' commitment to a sound policy framework.

Extending his remarks, Mr. Newman observed that in preparing for the forthcoming Board discussion on the review of stand-by and extended arrangements, the experience with nominal anchors--particularly the conditions where nominal anchors had succeeded in rapidly bringing down inflationary expectations and the steps needed to ensure that their use did not result in adverse competitive effects that could upset a program's external objectives--to be striking. He hoped that at the forthcoming discussion, that issue could be considered in greater depth to see under what conditions nominal anchors might be used more vigorously than in the past. He agreed with Mr. Autheman that Ghana might be a case where the ability to implement successful fiscal policies would allow for the use of a nominal anchor.

As to his concern about using privatization receipts to fund consumption rather than investment expenditure, a comparison could be made of the rates of return, Mr. Newman remarked. For example, in Ghana's case, using the proceeds to reduce outstanding external debt might pay greater returns than investing them in liquid assets, as interest rate payments on Ghana's debt were likely to exceed potential investment earnings.

Mr. Autheman said that he had no difficulty with Mr. Newman's comments on the use of a nominal anchor. He himself had drawn no specific conclusion with respect to Ghana. Rather, he had wished to underline that following several years of successful adjustment, sticking to the battery of tools used at the early stages of the adjustment process might be counterproductive, because the degree of downward flexibility of the exchange rate that was appropriate at a certain stage could lead to permanent and high inflationary expectations. He did not know whether Ghana was ready for a nominal anchor, but the issue should be examined carefully.

On the second point, he agreed with Mr. Newman that it was important not to use privatization proceeds for increased consumption, but whether they were used to reduce the fiscal deficit or external debt, or to develop profitable investment in the country was a matter of choice. In any event, there would be no benefit in building external assets that the country would, at some time in the future, feel pressed to sell to pay for consumption.

The staff representative from the African Department, commenting on performance with respect to end-June financial and structural benchmarks, said that data for end-April and end-May were currently being finalized. The authorities had assured the staff that, on the basis of preliminary data, the program remained on track. All structural benchmarks for June and the structural benchmark for September were expected to be met.

As to the impact of the ethnic conflict on the budget, the situation had settled down somewhat and a peace agreement between the warring factions was about to be concluded, the staff representative remarked. The economic impact would depend very much upon whether planting in the area had been completed before the start of the rainy season. Provision had been made in the budget to cover the cost of pacifying the area, and the staff hoped that that budget limit would be adhered to.

On the revenue impact of the increase in producer prices by 127 percent in 1995, the staff's calculations indicated that on the basis of projections for prices and cocoa exports for 1995, and assuming that no retrenchment costs would be incurred, cocoa revenues to the budget would remain flat relative to GDP in 1995, the staff representative commented. If the retrenchment program in the Cocoa Board continued, or if prices or volumes were somewhat softer than anticipated, there would be some fallout in tax revenues from those sources.

As to the classification of government expenditures, the staff understood that the category "other purposes" related to the setting up of electoral boards and parliamentary institutions, and outlays relating to ECOMOG peacekeeping forces in West Africa and other parts of Africa, the staff representative explained.

The fact that private sector savings were low in 1993 reflected the weaker than expected fiscal and monetary policies during 1992 and 1993, the staff representative continued. Consequently, there had been a strong surge in import demand, which, combined with a policy during the first half of last year of fixing the exchange rate at C 601 per U.S. dollar, had led to a large increase in imports, mostly in the form of consumption goods. In addition, the tax/GDP ratio had risen by 4 percent in 1994, which would tend to reduce both consumption and saving.

Some of the strong increase in imports consisted of stock building, particularly of retail inventories, the staff representative remarked. To the extent that those imports had not been taken into account in compiling the staff's investment figures, the drop in savings might have been understated.

The projected large drop in import volumes in 1994 following the strong increase in 1993 also related in part to the building up of stocks, the staff representative commented. To the extent that those stocks were not sold because of a decline in local demand, there should be an automatic drop-off in imports. In addition, the sharp depreciation of the exchange rate in the second half of 1993 and in the first few months of 1994, combined with the tightening of domestic financial policies since the beginning of the year, could be expected to result in much tighter aggregate demand in general, and, consequently, in lower import volumes.

Although the authorities appeared to be favorably inclined to removing the export monopoly currently held by the Cocoa Board, he understood that there was some strenuous internal political opposition to the idea, the staff representative explained. The staff and the authorities would be working to redress that situation. Certain modalities would need to be sorted out, including issues relating to the access of private traders to bank credit in the event that the Cocoa Board was phased out of existence.

The Bank of Ghana acquired its foreign exchange reserves through surrender requirements on receipts from gold and cocoa, the staff representative stated. The central bank only sold foreign exchange to the commercial bank market; it did not buy foreign exchange in the commercial bank market.

The staff shared some of Mr. Autheman's concerns about the excessively sharp depreciation of the cedi, the staff representative remarked. In the current program, however, the exchange rate was a safety valve to prevent an undue loss of foreign reserves in the event of slippages in the implementation of financial policies. In the staff's view, the exchange rate depreciation that had taken place reflected inflationary policies; it had not been a cause of inflation. There was no substitute for strong financial fiscal and monetary policies as a means of inducing price stability, including stability of the exchange rate. In the event, the exchange rate had been very stable in the past three months owing to the success of the budget policies announced in January and to the fact that monetary brakes were currently being applied, as reflected in the containment of aggregate demand. The exchange rate was expected to continue to be relatively stable as long as monetary and financial policies continued to be implemented as envisaged.

It was true that reserve requirements were high--over 50 percent, the staff representative commented. A large part of the increase in reserve requirements over the past two years reflected the laxity in the implementation of fiscal policies.

It was generally agreed that proceeds from privatization should not be squandered but should be utilized for asset accumulation or for debt reduction, the staff representative observed. The staff agreed with Mr. Newman that the only difference between the two approaches related to the relatively small spreads between lending and borrowing rates.

The relative weakness of the agricultural sector in Ghana in recent years was cause for concern, the staff representative from the African Department stated. The relative stagnation was due to the serious deterioration in international market conditions for Ghana's two major export cash crops, cocoa and coffee. The pickup in international prices for those crops in recent months should provide great incentives for replanting and for more intensive cultivation, and some rebound in output and activity in the agricultural sector could be expected as international market conditions.

Mr. Dorrington remarked that his chair agreed with Mr. Autheman and Mr. Mirakhor on the benefits of Executive Directors travelling to Ghana or other countries outside their constituencies. On other points, it was surprising that the effect of the catch-up of producer prices had been neutral. As to the expenditure on "other purposes," in view of the nature of the expenditure, it would be reasonable to expect a substantial decline in that category in the future, which would be generally helpful.

Mr. Dlamini made the following statement:

After several years of successfully implementing economic reforms, Ghana's performance in 1993 was mixed, with difficulties experienced in achieving some program objectives, especially in the financial area. Thus, the implementation of last year's program, which was intended to address the slippages of 1992, fell short of expectations. In particular, fiscal and monetary performance failed to meet the targets, inflationary pressures mounted, and the external current account position deteriorated. At the same time, output growth was better than anticipated, and further progress was made on improving the structural foundation of the economy that is critical to macroeconomic adjustment.

Faced with this situation, Ghana will need to take action to restore the fiscal and monetary discipline needed to consolidate the external position. I am encouraged by the authorities' willingness to take corrective measures in the context of their medium-term framework. In this respect, the policies for 1994 will concentrate on fiscal consolidation and structural reform to reduce inflation and strengthen the external sector.

In view of the limited opportunities for expenditure reduction, the authorities are concentrating on broadening the tax base in order to turn around the fiscal position. Already, a comprehensive list of new tax measures has been implemented, including those relating to import and excise duties, and income and property taxes. Shifts in expenditure are also being carried out, with the civil service wage bill and termination benefits likely to be further reduced. The authorities will also take the opportunity to reduce their domestic debt, including debt to the banking sector.

On monetary policy, I welcome the fact that progress is being made in containing broad money at the end-December 1993 level, thus reducing the annual rate of inflation to 22 percent and achieving some reduction in nominal interest rates.

On the structural front, we encourage the authorities to continue their efforts toward a further reduction in the role of the state in the economy. In this respect, we welcome the enactment of the new investment code, the continued divestiture of public enterprises, and the opening of cocoa marketing to the private sector. The authorities will also need to take measures aimed at improving public sector expenditure management and restructuring the public service.

With the weakening of the external sector in 1993, the authorities will need to take corrective measures in 1994. In this respect, I welcome the actions taken so far, which include liberalizing the exchange and trade system and ending bilateral payments arrangements. For the medium term, Ghana, like many other developing countries, will need to reduce its debt-service burden and strengthen the reserve position in order to guard against unforeseen shocks.

Ghana has made considerable progress in reforming its economy. However, the benefits of these efforts are not yet visible. The country will, therefore, continue to need the generous support of the international community.

Mr. Yang made the following statement:

Although Ghana's economic performance in 1993 fell short of expectations in the fiscal, monetary, and inflation areas as well as in containing the current account deficit and balance of payments position, the performance in other important areas was encouraging. Real GDP grew by 5 percent, and significant progress was made in structural and institutional reforms as reflected in the reform of cocoa pricing, preparation for the VAT, and divestiture. This chair commends the authorities for these achievements.

Unlike last year's program, which was ambitious, the program for 1994 is characterized by the staff as realistic and feasible, and represents a balanced and well-designed strategy to deal with existing macroeconomic problems. As highlighted in Mr. Mirakhor's comprehensive statement, the authorities have rightly emphasized stabilization efforts in order to strengthen fiscal policy. I am in general agreement with the staff appraisal and wish to make a few general comments.

The Ghanaian authorities are encouraged to persist in their efforts to pursue a tight fiscal policy. The slippage in the fiscal policy and inflation areas in 1993 was partly due to factors beyond their control as well as to the failure to implement measures to increase revenue and contain expenditure. The fundamental cause of the sizable monetary expansion in 1993 and, hence, the more than doubled inflation rate of 1992--28 percent--was the deterioration of the overall fiscal position, which fell from the programmed surplus of 0.3 percent of GDP to a deficit of 2.5 percent of GDP. On the revenue side, slippages also occurred in the area of tax performance, as reflected in the failure to increase the petroleum tax as planned and to further adjust the retail prices in accordance with exchange rate changes. There were also difficulties in the customs administration. I share the staff's view that expenditure control needs closer attention, and that the authorities should aim at improving monitoring and management. I would also welcome further comments on why current expenditure in 1993 overran by some 58 percent that of the previous year, as well as on the corrective measures to deal with the consequent monetary expansion and inflation issues. Ghana's experience in these areas may be helpful for a successful implementation of the 1994 program, which seeks to avoid some of the pitfalls in the implementation of the 1993 program.

Real GDP grew by 5 percent in 1993, and I am pleased to learn from the staff that this growth rate will be maintained for the coming three years. This rate exceeds the population growth rate and should help reduce poverty. In order to build on this growth momentum, persistent efforts are required in the agricultural and mining sectors, which are the two major contributors to last year's economic growth. The structural reform focusing on promoting private sector activity and foreign investment is supported by various legislative, regulatory, and financial policy measures that are already in place. While this is a step in the right direction, gross investment--at 14.8 percent of GDP in 1993--was comparatively low, and a gross national savings rate of 5.4 percent of GDP is too low for a developing country. These rates are programmed to improve gradually over the program period, giving an encouraging prospect for future growth. Nevertheless, the authorities are urged to intensify their efforts, particularly with regard to demand management and the maintenance of positive interest rates, which are critical to generating resources for the acceleration of investment and growth.

We welcome the authorities' recent action in accepting the obligations of Article VIII. This demonstrates their commitment to a liberal exchange system, which will help enhance their international competitiveness.

Mr. Gaspard made the following statement:

Notwithstanding the positive developments in output growth in 1993, I agree with the staff's central recommendation, namely, that Ghana needs to achieve considerable fiscal adjustment to restore financial stability and the conditions necessary for sustained growth. Fortunately, owing mainly to favorable developments in the export sector, Ghana today is in a substantially better position to achieve the needed fiscal adjustment than it was in 1993. With the recent increases in the international prices of cocoa and gold, Ghana's terms of trade have improved considerably after many years of continuous decline.

While I welcome the authorities' 1994 strategy for fiscal adjustment based on a broad package of measures aimed at raising total revenues some 4 percentage points of GDP in 1994, I have some concern regarding the vulnerability of the fiscal accounts in the medium term. Looking at the targeted fiscal improvement in 1994 of 3.4 percent of GDP, we find that 1.4 percent is to come from cocoa exports, 0.5 percent from the petroleum tax, while the $110 million divestiture receipts assigned to the budget account for about 2 percent of GDP. As the large increase in revenues from cocoa exports is due mainly to the recent sharp rise in export prices and the effect of the cedi depreciation, this revenue source is obviously vulnerable to terms of trade reversals. In addition, without an automatic retail pricing formula for gasoline that would prevent an erosion of tax revenue by making it more responsive to landed costs, the authorities may find their revenue from petroleum excise taxes quickly eroding. Therefore, I am encouraged to hear from Mr. Mirakhor that the authorities are giving careful consideration to the staff's proposal on a retail pricing formula for gasoline. Ultimately, divestiture funds, while welcome, cannot be counted on as a recurrent source of revenue.

On the expenditure side, I welcome the shift in the composition of government expenditure by the further reduction of the civil service wage bill. However, I note that interest costs are expected to rise considerably in 1994 and endorse the staff's suggestion to apply any excess funds from the divestiture program to debt reduction, particularly nonconcessional foreign debt, so as to reduce the interest burden in the medium term.

In addition to the fundamental fiscal problem to be addressed, there seems to be a risk of a surge in consumption demand to take advantage of the favorable external developments. Furthermore, private savings and private investment have already fallen sharply, to about 2 percent and 5 percent of GDP, respectively, in 1993. This is a disturbing phenomenon. I would appreciate the staff's comments on this development. Furthermore, credit to the rest of the economy, which includes the private sector and parastatal enterprises, has increased by more than 20 percent in real terms in the first quarter of 1994. I would appreciate some details on the type of activities that this credit growth has been financing.

To bring about a dynamic private sector that will make the economy more productive and its growth more sustainable also requires structural reforms, which the authorities seem intent on implementing. A welcome development in this respect is the recent enactment by Parliament, in March, of a new investment code. Of the various other structural reform measures that are proposed by the staff, I would merely underline the importance of removing the Cocoa Board's export monopoly, and of carrying out the proposed privatization program, especially for state-owned banks. It is heartening to note that the Ghanaian authorities have so far displayed a commendable resolve to implement the necessary stabilization and reform measures in order to improve the immediate and long-term performance of the economy. I am confident that, with careful management and continued vigilance, the authorities will bring the Ghanaian economy back on course.

Mr. Rigász made the following statement:

The indicators for 1993's economic program show that Ghana's Government was unable to completely shake off the legacy of its 1992 fiscal profligacy. Although the target for real GDP growth was approached, the situation on the monetary and external fronts remained difficult, as shown by the more than doubled inflation rate and by the highest deficit of the current account ever on record at the end of 1993. While the authorities managed to boost budget revenues by more than 5 percent of GDP over 1992--a remarkable achievement indeed--laxness on the expenditure side undermined their fiscal surplus target, and the year ended with a deficit of 2.5 percent of GDP. In the area of structural reform, the Cocoa Board retrenchment and the progress with the divestiture program were welcome steps in the right direction.

With regard to the program for 1994, I am glad that the authorities, aware that key corrective action is called for on the fiscal side, have recognized the need for further tightening leading to a stricter budget secured by monetary and fiscal prudence. I would also like to commend the authorities for their intention of having the program informally monitored by the Fund's staff and to welcome Ghana's acceptance in February of the obligations under Article VIII.

As I broadly agree with the thrust of the 1994 program and with the staff's assessment of the present situation, I will limit myself to three specific comments.

With respect to the system of import taxation, I share the staff's view that a reduction of the effective rate of protection should be considered as soon as budgetary circumstances permit. In view of the current recovery in the prices of commodities, now is the appropriate moment to reduce import duties and compensate for this action with the additional income resulting from the surge in export prices. Ghana risks being isolated in the West African region if it maintains its protective import taxes, because the region has recently been strengthened by the re-establishment of competitiveness in the CFA franc zone and by the resulting further integration in the West African Economic and Monetary Union.

If the gains brought about by a favorable external environment are sustained over the year, would the staff still feel that there is a need for a further depreciation of the exchange rate? In a situation in which the bulk of export prices is exogenously determined, continued depreciation will only rekindle inflation, without having much impact on the competitiveness of the country in the short run, although over the long run, increased income in local currency for the enterprises and increased government revenues from export taxes are likely to reinforce the supply response of the economy. Even so, would it not be more advisable to encourage the authorities to keep inflation below the targeted level as long as growth perspectives are sufficiently strong to allow for a further policy tightening without endangering excessively income performance? Such an approach might also be warranted in view of the possible adverse effect on prices of the soon-to-be-implemented VAT system, and taking into account the inflation target of 5 percent for 1996.

I have some difficulty in reconciling the growth target of 5 percent in 1994 with the envisaged reduction in imports. Historically, growth has been clearly correlated with the volume of imports, which is not surprising in a country where growth performance is heavily dependent on imports of investment goods. In view of the trend increase of imports over the past six to seven years, with an average growth rate slightly below 5 percent, can we reasonably expect a sudden decline in imports while still achieving 5 percent growth?

A viable solution for Ghana's medium-term prospects is to be found in the reduction of the country's vulnerability to external shocks. This could be accomplished by stepping up the process of structural reform focused on diversifying the export base. Generating the savings necessary to fund investment and growth from domestic sources will play a critical role in this process.

Mr. Pillath made the following statement:

It is regrettable that Ghana, which sometimes has been labeled a "frontrunner in adjustment" in sub-Saharan Africa for its reform experience in the period after 1983, did not succeed better under the Fund-monitored program for 1993. Ghana's financial performance fell short of expectations, and most of the program's benchmarks were not observed. The success in some areas of structural reform cannot hide the fact that inflationary pressures intensified and the current account deficit widened sharply.

We therefore welcome the "realistic and feasible" program that has been formulated for 1994, which aims at lowering the inflation rate and reducing the external current account deficit. Considerable fiscal adjustment combined with an acceleration of the divestiture program and an increase in private sector investment, foremost in the export-oriented manufacturing industry, will be essential to ensure a satisfactory economic growth rate over the coming years.

As I fully agree with the thrust of the staff's appraisal, I will only make some observations and raise only a few questions.

Obviously, financial resources of a given size are required for a corresponding increase in investment. In view of the still strong inflationary pressures in the economy, I wonder how gross national savings will increase from 5.4 percent in 1993 to almost 10 percent in 1994. Further explanation by the staff would be appreciated.

We agree that corrective actions in the fiscal area remain the key to the necessary stabilization effort. On the revenue side, broadening the tax base by removing tax exemptions and sources of tax leakages are important elements in a broad package of measures aimed at raising total revenues, in view of the limited scope for spending cuts. Along these lines, we would, like the staff, express our concern that new tax exemptions under the new investment code might undermine the revenue effort. In this context, it is also important to combat corrupt practices that deter potential investors.

According to our information, in Ghana only 1.2 million of those formally employed are registered as taxpayers. This may be one reason the share of income tax revenues in the budget is relatively small. The fact that the share of income tax is on a downward trend from about 16 percent of total revenue in 1993 to 13 percent in 1994 might also be taken as an indication of the growing importance of Ghana's informal sector. In a recent interview, Ghana's Minister for Trade and Industry underlined the relevance of the informal sector for the Government as a major potential source of income and jobs, as a provider of money and savings, and as a flexible user of inputs and technology. One might get the impression that in the Government's assessment, the benefits from the informal economy still outweigh the benefits of taxing the informal activities. Perhaps the staff could comment on the Government's strategy to tax informal economic activities.

The staff points out that the scope for substantial spending cuts is limited. The reduction of the wage bill as a share of GDP will be one important element to contain expenditures. Some sources say that in 1993 the wage bill was actually higher than suggested by official figures, as an additional amount was taken from the Government's capital account. In the 1994 budget, we note that capital expenditures are projected to increase by almost 50 percent, which could raise the question of whether there is a risk that the wage targets in the budget for 1994 could be undermined by "hidden wage expenditures." Staff comment on this point would be welcome.

The authorities should make every effort to strengthen the export sector. We fully support all recommendations to increase private sector participation in the cocoa market and especially the removal of the state export monopoly. The reliance on cocoa in the medium term, however, might not be as beneficial, as Ghana remains particularly vulnerable to events in a vulnerable market outside of its control. Thus, the Government should make extensive efforts to diversify and expand nontraditional exports.

The staff papers clearly show that despite the improved macroeconomic data base, considerable delays and lags persist in the publication of national income, government finance and balance of payments statistics in labor market data, and financial performance of major parastatals. Therefore, we would urge the authorities to improve statistical documentation of economic developments.

Ms. Laframboise made the following statement:

Although overall economic performance in 1993 left something to be desired, we recognize the difficulties posed by the change in the political process in Ghana. Moreover, we acknowledge and welcome Ghana's continued commitment to bringing economic performance back on track.

We agree with the staff's appraisal and recommendations. On a general basis, we are concerned by the rise in external debt, which has almost doubled from 54 percent of GDP in 1991 to 95 percent in 1994. Consequently, we feel that a greater effort is required to raise domestic savings in order to avoid recourse to commercial borrowing.

In this context, we note that total government expenditure and net lending has risen from 18 percent of GDP in 1991 to 30 percent in 1994. Excluding capital outlays financed through external project aid, total expenditure as a share of GDP has risen from about 14 percent of GDP in 1991 to 21.2 percent in 1994. Yet the staff notes in the report that "the scope for significant spending cuts is limited." We wonder why the staff sees no scope for any spending cuts, given these large relative increases over such a short period?

We support the view that sustained corrective action on the fiscal front is the key to stabilization. We have several questions on some specifics in the budget. First, we note the measures to raise revenues by increasing the average import duty rate from 5.8 percent to 8.7 percent. From the report, we understand that there will now be three rates: zero for a few exempted items, 10 percent, and 25 percent. While this should reduce the incidence of underinvoicing, does the staff have any concerns that this increase in the average could lead to increased smuggling, thereby offsetting revenue increases?

Second, we welcome the reduction in the civil service wage bill as a share of GDP and the focus on "pay relativities" to reward merit and productivity. With respect to the latter, will these pay relativities apply only to "managerial staff"? They should apply to all high caliber employees--not only managerial staff.

Third, we understand that the principal amounts included under the "subsidies and transfers" line in the budget are in the form of transfers to local governments. Are these statutory payments, and is there any flexibility in the amounts?

On monetary policy, like others we were disappointed by the inflation outcome in 1993. We would simply stress the importance of adhering closely this year to program benchmarks on central bank financing of the Cocoa Board and the government budget.

On other staff advice, we fully support the recommendations to remove the monopoly on cocoa exports from the Cocoa Board, to use privatization proceeds to pay down debt rather than for budgetary purposes, and to adopt an automatic domestic pricing mechanism for petroleum products.

Ghana has consistently taken brave strides since the early 1980s to stabilize and adjust its economy in the face of daunting and unique externalities. However, the rate of progress slowed in 1992 and 1993 and risks stagnating or reversing if the authorities fail to solidify their commitment and keep their program on track. This would be unfortunate, particularly as the rewards from the adjustment process have begun to reach a greater number of economic agents. We would strongly urge the authorities to follow through on the items highlighted today in order to ensure that progress is revitalized. Adherence to a sound program should raise the confidence of external donors and bolster official transfers and foreign capital flows, thereby limiting Ghana's need to raise its external debt level.

Ms. Srejber made the following statement:

As I am in broad agreement with the staff appraisal and policy advice, and as other Directors have already covered any additional points, I would only raise one question concerning the public debt and arrears. According to the staff report, Ghana follows a policy of paying all its debts and has had no payment arrears since 1990. However, according to the information I have received from my Norwegian authorities, the Norwegian Export Guarantee Institute has had recurring problems with repayments from Ghana on their loans, which are acknowledged by the Ghanaian authorities as a public debt, and now amount to roughly $12 million. This is not a large amount, and following my contacts with Mr. Mirakhor and the staff, I am sure that we will be able to sort out the matter, but I would appreciate staff comment on this issue.

The staff representative from the African Department said that the overruns in current expenditure in 1993 were largely due to three elements: a salary advance granted to civil servants toward the end of 1993 to bridge the general salary increase to be given in May 1994; unanticipated expenditures relating to ECOMOG peacekeeping efforts; and domestic interest payments owing to the larger than expected domestic borrowing requirement. In addition, the central bank had engaged, particularly in the last quarter of the year, in large open market operations designed to soak up the increase in liquidity that had emanated from the slippages in fiscal performance.

The low level of savings recorded in 1992/93 was clearly unsustainable, the staff representative stated. The underlying objective of the macroeconomic program for 1994 was to mobilize domestic resources, maintain real interest rates, and dampen the demand for imports and consumption. The objective was try to achieve a target for nongovernment savings of about 13 percent by 1996.

The sharp rise in private sector credit in the first quarter of 1994 was almost exclusively due to a short-term central bank credit to the petroleum company, which had found its cash flow tightly squeezed owing to the combined effects of the rapid depreciation in the exchange rate toward the end of 1993 and the absence of any increase in retail prices, the staff representative explained. That borrowing should be fully repaid by the end of June.

There was no concrete program for addressing the taxation of informal activities, the staff representative commented. The authorities' medium-term objective was to shift the emphasis placed on tax revenue from direct sources--particularly from the income tax--to indirect taxes. In January 1995 a value-added tax would be introduced, which would provide a much broader base for raising indirect taxes.

The large increase in the capital budget was related in part to a provision to pay down the arrears that had been accumulated vis-à-vis domestic suppliers, the staff representative observed. It did not reflect an attempt to capture any increase in wages.

On the matter of the arrears vis-à-vis the Norwegian Government, the staff had been in contact with the Ghanaian authorities, the staff representative from the African Department stated. He understood that Ghana was in the process of approaching the Norwegian authorities with a request for the renegotiation of the debts and, pending a resolution of the matter, was withholding payments.

The staff representative from the Policy Development and Review Department, commenting on the recent increase in import duties, observed that the average duty rates in Ghana were low relative to those of other countries in the region, even with the recent movements. The staff's concern was not that the rate was too high, but rather that the increase could be seen by the private sector as a reversal of the original policy of import liberalization and the wish to maintain the direction of policy and the confidence of the private sector.

Mr. Mirakhor said that he had become aware of the arrears to the Norwegian Export Guarantee Institute only that morning. According to his authorities, payments were being withheld pending the conclusion of negotiations with the Norwegian authorities on some disputed matters. As soon as he received the documentation on the arrears from Ms. Srejber, he would forward it to his Ghanaian authorities.

He wished to assure Mr. Pillath that the Government had every intention of holding the line on wage increases, Mr. Mirakhor continued. He would note in that regard that in a recent speech, the President of Ghana had stated that "as far as the salaries are concerned, the Government cannot do more than it has already proposed. If demands made by certain categories of workers are accepted by the Government, the consequences on the value of the cedi and its implication on the economy could be disastrous." The salary increase already granted was, in fact, much below the increase in prices.

On the dismantling of the monopoly of the Cocoa Board, the staff report provided good coverage of the steps that the authorities had taken to increase the efficiency of the Cocoa Board while trying to reach a political decision that might allow for the elimination of its monopoly, Mr. Mirakhor stated.

The conflict in the North had erupted in February 1994, and the Government had since tried to reach a peace settlement, Mr. Mirakhor remarked. On June 9 an agreement had been signed by all parties that provided for a cease-fire and the beginning of negotiations for the settlement of disputes on June 27. The Government was hopeful that all disputes could be settled through peaceful negotiations. There was, however, some uncertainty regarding the economic impact of the conflict. As the budget was being prepared while the conflict was going on, some reasonable estimates of its budgetary burden had been programmed into the budget. The impact of a massive refugee problem, however, had yet to be assessed. The impact on agriculture was not substantial, as the conflict had started in the dry season. If all disputes were settled by the harvesting season--August and September--the harvest would not be affected.

His Ghanaian authorities had always valued the comments and guidance of the Board, Mr. Mirakhor observed. He would immediately convey Directors' comments to his authorities, who would give them the fullest possible consideration.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They noted that, notwithstanding progress made in stabilizing the economy and strong economic growth, performance under the 1993 staff-monitored program generally fell short of expectations. In particular, the improvement in the overall fiscal balance relative to GDP was only about one half of what had been envisaged. This slippage partly reflected the failure to implement a planned increase in petroleum taxes and to pass the impact of the depreciation of the cedi to retail petroleum prices. In addition, while the civil service wage bill was contained, there were substantial spending overruns in other areas of the budget. As a consequence, the monetary targets were not met, inflationary pressures mounted, and Ghana's overall balance of payments position was weaker than expected. At the same time, Directors observed that progress on the structural front had been satisfactory, particularly with regard to the implementation of the divestiture program.

Directors welcomed the authorities' commitment to implementing a comprehensive stabilization and structural adjustment program for 1994, which would be informally monitored by the Fund staff. The restoration of strict financial discipline and a reduction in inflation would be essential to return the economy to a path consistent with external viability and sustainable growth. Directors welcomed the progress made with respect to expenditure control at the payments stage; this needs to be complemented by better monitoring and control at the commitment level. They noted with satisfaction that the program targeted an overall fiscal surplus, and that the strategy for achieving this objective was based on a broad package of measures. Directors, however, encouraged the authorities to pass through unanticipated increases in oil import costs. They also urged the authorities to continue their efforts in resisting pressures for large public sector wage awards, noting the adverse effect of such awards on fiscal performance and the international competitiveness of the economy more generally. Directors remarked that the central bank needs to allow interest rates to rise if necessary to meet the program's objectives.

Directors supported Ghana's structural reform efforts. In particular, they welcomed the good progress being made in implementing the divestiture program, which provides a clear signal to local and foreign investors of the Government's commitment to enhancing the role of the private sector in Ghana's economic development. Noting that proceeds from the sale of public assets represented a nonrecurrent source of funding, some Directors supported the strategy of using these proceeds for the retirement of domestic and external debt, while a few urged that they should be directed toward market-oriented domestic investment. They also expressed satisfaction with the steps that are being taken in the cocoa sector. The operating costs of the Cocoa Board had been contained, strong price incentives had been provided to cocoa farmers, and the domestic marketing of cocoa had been liberalized.

There was also a valuable exchange of views on Ghana's exchange rate policy. It was noted that the flexible exchange rate policy acted as a safety valve against weaknesses in policy implementation and in order to avoid undue losses of foreign exchange. But it was also observed that the currency depreciation over the years may well have strengthened the anticipation of continuing inflation and that greater stability of the exchange rate could contribute to greater price stability. Directors were agreed, however, that the first priority was to strengthen macroeconomic--and particularly fiscal--policy.

Directors noted that external assistance to Ghana was expected to remain at relatively high levels through the medium term. They therefore emphasized the importance of structural reforms and domestic resource mobilization as key elements in diversifying economic activity and in achieving external viability. Directors welcomed the recent acceptance by Ghana of the obligations of Article VIII, which demonstrated the strength of the authorities' commitment to maintaining a liberal exchange system.

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

4. REPUBLIC OF GEORGIA - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the staff reports for the 1994 Article IV consultation and recent economic developments in the Republic of Georgia to the Commission of the European Communities, the European Bank for Reconstruction and Development, the Organization for Economic Cooperation and Development and the United Nations Development Program.

Adopted June 24, 1994

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/94/56 (6/23/94) and EBM/94/57 (6/24/94).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 94/1 are approved.

APPROVAL: September 19, 1995

LEO VAN HOUTVEN
Secretary