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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/64

10:00 a.m., June 30, 1995

Contents

Executive Board Attendance

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

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	S. Al-Huseini, Temporary
	O. Himani, Temporary
M.-A. Autheman	P. Cailleteau, Temporary
	E. Srejber
	B. Andersen, Temporary
L. E. Berrizbeitia	V. J. Fernández
	J. Guzmán-Calafell, Temporary
I. Clark	G. F. Murphy
	R. Rainford, Temporary
B. S. Dlamini	
H. Evans	
	W. Hettiarachchi
	R. Kannan, Temporary
	L. M. Cheong
	K. Link
A. Kafka	A. Calderón
	G. P. Ramdas, Temporary
W. Kiekens	J. Prader
	A. R. Ismael,Temporary
	J.-C. Obame, Temporary
	K. Kpetigo, Temporary
G. Lanciotti	N. Coumbis
K. Lissakers	M. W. Ryan, Temporary
	J. B. Wire, Temporary
	T. Fukuyama
	T. Oya, Temporary
A. Mirakhor	
C. Saito	A. G. Zoccali
S. Schoenberg	E. Wagenhoefer
A. S. Shaalan	T. K. Gaspard, Temporary
	A. V. Mozhin
	A. Vernikov, Temporary
	M. Petrie, Temporary
J. de Beaufort Wijnholds	G. Mucibabici, Temporary
Zhang M.	Wei B.
	He J., Temporary

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

Also Present

IBRD: F. R. Najm, Africa Regional Office; E. M. Rice, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; R. K. Basanti, C. Brachet, K. J. Cady, D. G. Cowen, G. Devaux, T. Ehrbeck, C. A. François, J. Kakoza, M. Nowak, R. Prem. European I Department: M. Russo, Director; B. Arnason, L. A. V. Catao, M. J. Fetherston, D. J. Ordoobadi. External Relations Department: S. J. Anjaria, Director; F. Baker, D. R. Hawley, H. P. Puentes. Fiscal Affairs Department: A. Cheasty, L. U. Figliuoli, L. Schuknecht. Legal Department: H. Elizalde, S. Gong. Middle Eastern Department: E. Maciejewski. Monetary and Exchange Affairs Department: D. E. Dueñas, E. Feldman, G. G. Garcia. Policy Development and Review Department: J. T. Boorman, Director; D. N. Lachman, Deputy Director; T. Leddy, Deputy Director; P. F. Allum, H. M. Flickenschild, D. J. Goldsbrough, B. Horvath, C. Puckahtikom, S. M. Schadler. Research Department: M. Mussa, Economic Counsellor and Director; R. A. Feldman, F. Larsen, J. E. Roldos, M. A. Savastano, M. G. Spencer. Secretary's Department: J. W. Lang, Deputy Secretary, S. Bhatia, B. R. Hughes, A. Mountford, M. J. Papin. Treasurer's Department: G. Wittich, Deputy Treasurer; J. E. Blalock, A. W. Lake. Western Hemisphere Department: C. M. Loser, Director; M. E. Bonangelino, Deputy Director; E. Hernández-Catá, Deputy Director; B. Fritz-Krockow, O. Gronlie, V. H. Juan-Ramón, J. Thornton, F. van Beek, E. S. Williams. Office of the Managing Director: S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant; D. Burton. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, A. Chang Fong, A. Cserés, S. S. Farid, S. K. Fayyad, J. Jonáš, J. Justiniano, J. Leiva, Y. Margoninsky, M. F. Melhem, H. Mori, S. O'Connor, C. F. Pillath, K. Sundara. Assistants to Executive Directors: S. Arifin, R. D. Bessone Basto, M. A. Brettschneider, A. G. Cathcart, J. A. Costa, D. Daco, J. Dagustun, D. Desruelle, C. Duenwald, A. Galicia, H. Golriz, C. M. Gonzalez, A. Guennewich, M. A. Hammoudi, G. H. Huisman, C. Imashev, P. Jilek, T. Kanada, W. C. Keller, E. Kouprianova, G. A. Kyriacou, N. Laframboise, J. Mafararikwa, Ng C. S., J. Pesola, N. Prasad, J. Roaf, K. Sakr, G. Schlitzer, Song J., V. Verjbitski, R. von Kleist, Wang Y., E. Zamalloa.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director said that he had recently traveled to Israel to attend a conference on the tenth anniversary of the stabilization program carried out by Israel since 1985. During his trip, he had also had an opportunity to visit the Gaza Strip and the West Bank.

At the conference on the anniversary of the stabilization program, the former Primer Minister of Israel had explained the political thinking that had taken place in Israel in the mid-1980s, and economists from both Israel and the United States had given an overview of the political and economic situation prevailing in the country in 1985, and the actions that had been taken to improve it, the First Deputy Managing Director recalled.

During his visit to the Gaza Strip, he had met with the Minister of Finance, other government officials, and local businessmen to discuss the problems currently confronting the region, the First Deputy Managing Director stated. From his travels in the Gaza Strip, he had received the impression that the situation there was much less severe than indicated by recent press reports. A great deal of building was under way, even in the refugee camps, and a variety of amenities, such as gardens and beach resorts, were becoming available to the public for the first time in 20 years.

Nevertheless, serious problems remained, in particular with respect to trade, the First Deputy Managing Director commented. As a security measure, all goods were required to be transshipped at the border, so that Palestinian trucks would not enter Israel and vice versa. That practice had raised the costs related to the transportation of goods significantly and it had led to delays in shipment. As a significant portion of the Gaza Strip's exports were agricultural, some of its exports, such as tomatoes and flowers, had lost access to important markets.

In his discussions with the authorities and businessmen, many concerns had been expressed about the difficulties involved in living in an area that was essentially closed in, the First Deputy Managing Director said. Nevertheless, as the border with Egypt had recently been opened and facilities had been put in place for the transshipment of goods through that country, it was to be hoped that the situation with respect to trade would improve soon.

During his travel to the West Bank, he had met with a group of businessmen, who had been successful in attracting a great deal of foreign investment to the area, the First Deputy Managing Director recalled. From those discussions, he had ascertained that there was reason to be optimistic that, once the full empowerment of the West Bank came into effect in July 1995, it would encounter fewer problems in establishing a stable macroeconomic framework than had been the case for the Gaza Strip.

In Israel, the publication of the summing up of the 1994 Article IV consultation by the authorities had led to a great deal of controversy, the First Deputy Managing Director noted. He had taken an opportunity to explain to the press that the summing up had been intended to commend recent progress, while pointing to the serious difficulties that persisted with respect to the large current account deficit and the inflation rate, which had been very difficult to reduce below double-digit figures.

While in Israel, he had met with the Finance Minister and the Foreign Minister to discuss recent economic developments in Israel and its relationship with neighboring countries, the First Deputy Managing Director stated. The results of those discussions would be reflected in the forthcoming staff report on the 1995 Article IV consultation with Israel.

Mr. Mirakhor asked whether there had been any improvement in the flow of external assistance to the Palestinian authorities over recent months, or whether any improvement was likely to be forthcoming.

The First Deputy Managing Director replied that flows of external assistance were taking place. However, difficulties had arisen, because much of the external assistance originally committed to the Palestinian authorities had been geared toward support for development projects; in the event, there had been a need for support for current budgetary expenditures, and it had been difficult to transfer that assistance into support for the budget.

The Fund was providing technical support to the Palestinian authorities in the area of fiscal affairs, and the staff was monitoring developments with respect to the budget, the First Deputy Managing Director noted. While tax collections were in line with the staff projections for 1995, there had been overruns with respect to recurrent expenditures, which called for improved expenditure controls. At the present stage, there were some potential financing problems, and the authorities had been drawing on credit from local banks. The hiring of government employees had exceeded expectations. Some difficulties had also arisen with respect to certain development projects, although those projects were now getting under way.

The economic situation of the West Bank and the Gaza Strip would be analyzed in detail in the context of the 1995 Article IV consultation with Israel, the First Deputy Managing Director said.

2. MEXICO - 1995 ARTICLE IV CONSULTATION; AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with Mexico and the review under the 18-month stand-by arrangement approved on February 1, 1995 (EBS/95/103, 6/14/95;

Cor. 1, 6/27/95; and Sup. 1, 6/20/95). They also had before them a background paper on recent economic developments in Mexico (SM/95/153, 6/23/95).

The Director of the Western Hemisphere Department made the following statement:

> The following information updates the staff report for the 1995 Article IV consultation with Mexico and the second review under its stand-by arrangement. A few relevant charts are attached. 1/
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> With respect to the performance criteria, preliminary data indicate an increase in net international reserves from end-March to June 27 of about US$3.7 billion. On this basis, the deviation in net international reserves with respect to the June target should be about US$3 billion, compared with a deviation of US$6 billion in March. The cumulative fiscal primary surplus rose to MexN$37 billion in April, from MexN$25 billion in March, and the overall fiscal surplus to MexN$14 billion from MexN$9 billion.
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> Consumer prices rose by 1.6 percent in the first 15 days of June, continuing the deceleration that began in May, when the increase in prices was 4 percent, compared with 8 percent in April.
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> Interest rates have continued to decline, as reflected in the fall in the 28-day cetes rate--at auction--from 52.2 percent on June 9 to 40.7 percent on June 28.
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> Preliminary data show a trade surplus of US$1.9 billion in the period from January to May 1995, compared with a deficit of US$7.2 billion in the same period during 1994; in this period, total exports were 30 percent higher than a year earlier, and imports 20 percent lower.

Mr. Guzmán-Calafell made the following statement:

> The strengthening of Mexico's economic adjustment program at the beginning of March, coupled with the external financing received in support of the program, has allowed the stabilization of the foreign exchange and financial markets during the second quarter of 1995. The interbank interest rate declined from a peak of 109.7 percent in mid-March to 44.05 percent on June 28, while the stock market recovered strongly and the peso appreciated by

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1/ See Attachment I.

about 16 percent vis-à-vis the U.S. dollar. Simultaneously, increased confidence in the economy's outlook contributed to the practical elimination of net capital outflows, as the demand for foreign exchange resulting from the amortization of tesobonos fell, and the difficulties faced by the banking system in rolling over external liabilities eased. In this context, Mexico has been able to gradually return to the international capital markets. My authorities wish to thank the Fund management and staff for their very efficient work and for the valuable discussions that have been held during the course of this review.

On recent economic developments and prospects, the rate of inflation increased substantially during the first months of 1995, mainly as a result of the depreciation of the exchange rate and some of the measures adopted to strengthen public finances. The monthly rate of growth of the consumer price index rose continuously during the first months of 1995, reaching a peak of 7.9 percent in April, as a result of the increase in the value-added tax. Subsequently, the rate of inflation has come down significantly; consumer prices rose by 4.2 percent in May, and by 1.65 percent in the first half of June. It is expected that the rate of price growth will continue to show a clear downward trend in the coming months, and to record an annualized figure of about 20 percent during the last quarter of the year.

Real GDP fell by 0.6 percent on an annual rate during the first quarter of 1995, as the strong growth of exports of goods and services, some 29 percent, was more than offset by sharp decreases in consumption, 8 percent, and investment, 18 percent. The largest output declines are expected during the second and third quarters of 1995, and GDP is projected to fall by 2-3 percent in 1995. The evolution of output has had a significant impact on the labor market. For instance, the number of workers insured in the Social Security Institute fell by 536,000 from November 1994 to April 1995. Moderate wage demands have prevented an even larger increase in unemployment; in May, wage adjustments in contractual negotiations averaged 11.2 percent--including productivity bonuses--compared with an accumulated increase of 31 percent from January to mid-June.

The strengthening of public finances during the first quarter of 1995 far exceeded the targets agreed under the stand-by arrangement. Notwithstanding a real increase in interest payments of 44.5 percent, the overall economic balance of the public sector--MexN$9.1 billion--more than doubled the program's target. This was made possible by a primary balance 96.8 percent higher in constant prices than a year before. The decline in noninterest expenditures, 15.1 percent with respect to the first quarter of

1994, is particularly noteworthy. On the basis of preliminary information from the financing side, the overall economic surplus of the public sector is estimated at MexN$5.1 billion in April. This establishes solid grounds to meet the fiscal targets for June.

Monetary policy has also maintained a very restrictive stance, which has been reflected in a stronger and more stable exchange rate, declining inflationary expectations, and a large accumulation of international reserves. This has allowed interest rates to fall sharply without a relaxation of monetary conditions. While the target for net domestic assets has not been met, the following clarifications need to be made.

The deviation is fully explained by amortizations of tesobonos in U.S. dollars and banks' external liabilities that exceeded the support received to meet these payments. As of end-May, the former amounted to an estimated figure of at least US$18 billion, compared with US$10.2 billion channeled to the Exchange Stabilization Fund.

Deviations decreased substantially during the period April-June. As of June 26, the corresponding figure, MexN$8 billion, is only one fourth of that observed on March 31, MexN$33 billion. If the figures were adjusted to eliminate the impact of the appreciation of the SDR with respect to the U.S. dollar on central bank liabilities to the Fund, a normal procedure in Fund programs, the deviation would fall to MexN$2.8 billion, and from US$2.7 billion to US$1.8 billion in the case of the international reserves target.

The fall in net domestic credit during the period April-June has been the result of both a decline in the monetary base and an increase in international reserves. In June 1995, the monetary base shows a decline in excess of 20 percent in real terms with respect to the same month in 1994.

Net international reserves rose by US$3.8 billion from March 31 to June 26, thus reducing the deviation from the target to less than one half of the amount observed at the end of the first quarter. The cumulative decline in net international reserves during 1995, as of May 31, stood at US$3.4 billion, despite the fact that amortizations of tesobonos and banks' external liabilities exceeded disbursements from the Exchange Stabilization Fund by about US$8 billion in the same period. It is also important to underline that the increase in reserves during the second quarter is equivalent to nearly eight times the figure assumed under the program for this period.

The Banco de México is committed to meet the targets agreed with the Fund for net domestic credit and net international reserves for the rest of the year. To this end, several measures have been undertaken to strengthen monetary control. These include: a new reserve requirement scheme, under which banks are compelled to offset within one month overdrafts in their central bank accounts, thus allowing the central bank to tighten monetary conditions more rapidly; a modification of auction procedures in open market operations by which the central bank has practically no direct influence in determining interest rates; the decision not to satisfy passively the demand for bills and coins; and reforms to the payments system aimed at reducing the risks assumed by the central bank.

My authorities will maintain the floating exchange rate regime for the time being, and it is expected that the mechanisms introduced to hedge exchange risks will make its functioning more efficient. The maintenance of a floating exchange rate regime is consistent with compliance with the international reserves target, as the central bank can accumulate reserves without directly intervening in the foreign exchange market through commercial banks' amortizations of credits in U.S. dollars granted by the Fund for the Protection of Savings, and the Banco de México's operations with the Federal Government, PEMEX, and other public entities.

The contraction of aggregate demand resulting from the reduced inflows of net external financing and the measures implemented, has implied an impressive but orderly adjustment of the current account of the balance of payments. During 1994, a current account deficit of US$29 billion, or 7.8 percent of GDP, was observed. In the first quarter of 1995, the deficit fell to only US$1.2 billion and a surplus is estimated for April.

The evolution of the trade balance has been a major factor behind the decline in the current account deficit. In the period January-May, the trade surplus amounted to US$1.9 billion, in contrast with the deficit of US$7.2 billion observed in the same period of 1994. It is worthwhile to highlight some of the features that have accompanied this trend: contrary to the experience in 1982, the overwhelming part of the turnaround in the trade balance is explained by increased exports, rather than by lower imports; export growth has been rapid and generalized: manufacturing exports rose at an annual rate of 31 percent in January-May--43 percent if the in-bond industry were excluded--and while total purchases of capital goods abroad decreased sharply during this period, those associated with exporting firms showed an annual rate of growth of nearly 50 percent, suggesting a further buildup of the economy's export potential.

Mexico has gradually regained access to international financial markets since mid-April. A number of placements have been effected by commercial banks, while NAFIN and BANCOMEXT, two of the public development banks, issued over US$1 billion of commercial paper and medium-term notes in May and June. This past week, BANCOMEXT successfully placed a US$300 million floating rate note, representing the first large public issue in international markets since December 1994.

The actions initially introduced by my authorities to overcome the difficulties faced by commercial banks have evolved into a comprehensive strategy aimed at supporting banks while improving regulation and supervision. The results obtained to date have been satisfactory, as the position of banks has been strengthened and a systemic crisis avoided. By late June, progress in the implementation of the strategy was as follows.

Six banks have participated in the so-called PROCAPTE, the program for the capitalization of banks facing difficulties considered transitory. As a result, the group's average capitalization rate rose from 5.8 percent to over 9 percent. One bank will leave the program shortly, thus reducing the share of banks under PROCAPTE in total deposits from 28 to 14 percent. No additional banks are expected to enter the program.

Moreover, a number of banks have been able to repay loans in foreign currency granted through the special facility established at the Fund for the Protection of Savings to support those institutions unable to refinance external obligations. Thus, outstanding balances in this facility fell from a peak of US$3.8 billion in the first quarter to US$1.5 billion at the end of June.

Several programs have been launched for the long-run restructuring in Unidades de Inversión--a new unit of account whose value remains constant in real terms--of a portion of the bank's credit portfolio: one, amounting to MexN$76 billion, is designed to support mainly small and medium-sized firms considered economically viable; another, for MexN$17.4 billion, has been channeled to state and municipal governments. Similar schemes have been introduced for the restructuring of mortgages, some MexN$36 billion, as well as for loans granted by development banks and trust funds, MexN$13.4 billion. These programs will help to alleviate the difficulties faced by debtors, as the accelerated amortization of credits resulting from inflation will be eliminated, and the inflationary risk premium of interest rates will disappear.

A number of legal amendments to the financial legislation have been approved by Congress to improve the capitalization of the financial system through more flexible rules for domestic and foreign investment in financial sector institutions.

The Government has designed a specific bank recapitalization program, under which private investors inject additional capital to troubled institutions and the fund for the protection of savings purchases portions of their outstanding loan portfolios. The loan portfolios purchased by the Government, which need to be adequately provisioned, are paid at market value, with bonds, and include loss-sharing agreements. At the end of June, two operations of this kind had been effected, one of them involving the acquisition of 70 percent of capital of a domestic bank by a foreign bank.

A few days ago, the Inter-American Development Bank (IADB) and the World Bank approved loans for US$1.76 billion, which will be destined for the capitalization of the fund for the protection of savings and the streamlining of bank supervision.

To strengthen bank supervision, the National Banking and Securities Commission has begun a program of intensified on-site inspection. In addition, banks have been required to increase the level of provisions to the higher of 4 percent of the loan portfolio or 60 percent of past due loans; bank accounting practices are being modified; and a scheme of consolidated supervision will be applied to financial groups and individual intermediaries, among other measures.

The strategy adopted to support commercial banks has enhanced the stability of the financial system, provided additional degrees of freedom to monetary policy, and protected depositors, while minimizing the costs to the Government. It is expected that the efforts made to date will allow an improvement in the financial situation of debtors, fresh inflows of capital to the banking system, and a substantial strengthening of the framework of supervision. While the situation of commercial banks continues to be difficult, and there are still evident risks ahead, it is clear that the outlook today is better than it was a few months ago.

The policies implemented by my authorities to alleviate the social costs of the economic adjustment are described in the staff report and have been detailed in previous discussions of the program. However, it is important to mention that the IADB and the World Bank recently approved loans for a total of US$1 billion to support a number of social programs in the areas of health, education, nutrition, and employment generation.

As explained in the staff report, the progress made by Mexico during 1995 in the timeliness and efficiency of disclosure of information is significant. In addition to the measures in this area reported in the staff report, it is important to note that the Banco de México recently made available the country's main economic and financial variables through the Internet.

While the measures introduced and the external financing received have allowed a satisfactory evolution of the main financial indicators and a strong accumulation of international reserves during the second quarter of 1995, the challenges faced must not be underestimated. The most important in the short run is the extraordinary accumulation of tesobono amortizations in July and August, which has been reflected in the evolution of the exchange rate in recent weeks. Successfully overcoming this challenge would not be possible in the absence of adequate external financing. The greater the market confidence in Mexico's ability to effect the tesobono amortizations, the lesser the need to actually use the resources available. To allow a close monitoring of the economic program in these crucial months, a new target for net domestic assets and net international reserves has been introduced for end-July. Furthermore, my authorities are committed to eliminate deviations from the targets over the remainder of the year, and to further strengthen the policy stance, if this were needed. As the profile of tesobono amortizations should improve dramatically after August, the need for additional external financing will decrease in subsequent months. It is the expectation of my authorities that no additional Fund resources will be required after August, as long as the present trends continue.

Extending his comments, Mr. Guzmán-Calafell said that his authorities wished to express their appreciation to the Board, as well as to the Fund management and staff, for the exceptional support that had been provided to Mexico to help it overcome the recent financial crisis. His authorities were also grateful to the countries that had contributed to Mexico's Exchange Stabilization Fund, in particular the United States, whose support had been crucial throughout the various stages of the crisis.

Although economic adjustment in Mexico had been painful and a number of difficulties remained to be overcome, the outlook had clearly improved, and there were reasonable grounds for optimism, Mr. Guzmán-Calafell stated. The successes achieved thus far would not have been possible without the assistance received from the Fund, the United States, and other sources.

Mrs. Cheong made the following statement:

Today, we are seeing the first fruits of the comprehensive economic program that the Mexican authorities have pursued under the stand-by arrangement to address the peso crisis. The fiscal and external balances have turned around significantly, and investor confidence has improved, with the stock market and the peso staging a noticeable recovery. Indeed, as Mr. Guzmán-Calafell noted, the situation has improved sufficiently for the Mexican authorities to return to the international capital markets. The revival in market confidence is also evident from both the positive response to the recent Mexican public bond issue and the encouraging outlook for foreign direct investment. The confidence of international banks is further demonstrated by their willingness to roll over Mexican banks' short-term liabilities, so that the amortization of this external indebtedness is estimated to be lower than assumed under the program.

However, as the staff correctly pointed out, the situation is still fragile and certain risks remain, particularly as the loan portfolios of commercial banks continue to deteriorate in the face of a deepening recession. The bunching of maturing external obligations in the next two months has also created some uneasiness in the financial markets. Continued vigilance is therefore essential, to ensure that this recent revival in investor confidence does not dissipate. In particular, market players are looking to the Fund for reassurance that sufficient resources will be forthcoming for Mexico to meet its external obligations. For this reason, I support Mexico's request for the necessary waivers for the completion of the second review under the stand-by arrangement. I also support the proposed decision granting Mexico the right to make purchases for the total amount of SDR 12.1 billion, for the period February 1, 1995 to August 15, 1996, without further review by the Fund.

In the light of the Mexican authorities' assertion that they may not need to draw on Fund resources after August, I can appreciate the call put forward by several Directors in a memorandum to the staff to consider making Mexico's additional scheduled purchases subject to further reviews. 1/ However, I am not sure of the legal implications of such a suggestion. As I understand it, the amounts approved under stand-by arrangements have never been subject to review. Nevertheless, access to the stand-by arrangement resources will continue to be subject to periodic reviews, and this would give Directors ample opportunity

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1/ See Attachment II.

to review Mexico's balance of payments need to make new purchases in the future. In addition, the Fund can, if it considers that the balance of payments position is adequately strong, request the member to make an early repurchase. Staff comments on this issue would be welcome.

In any event, I would caution against any attempt to review Mexico's access to Fund resources at this juncture, as it would be interpreted negatively by the markets as a signal that the Fund is having second thoughts on the sustainability of Mexico's economic program. This could well precipitate another confidence crisis and undo the progress achieved thus far by the Mexican authorities. Hence, it is vital that the Fund approves the augmented stand-by arrangement for Mexico, as outlined in the proposed decision; to do anything less would run the risk of undermining market confidence in Mexico.

An unequivocal Fund decision on this matter is particularly important as information on disbursements from the Exchange Stabilization Fund for Mexico is incomplete. I wonder whether Ms. Lissakers or the staff could enlighten us on the schedule of Exchange Stabilization Fund disbursements, so that we might have a clearer picture of the total financing package for Mexico. This will, I am sure, go a long way toward allaying market concerns about the adequacy of financing resources to cover the large stock of maturing tesobonos.

The staff will encourage the authorities to cease making new purchases after August and even commence repurchases as soon as Mexico's international reserves position improves. I would suggest a more cautious approach, in view of the still fragile situation. The projected improvement in the trade account is due to a sharp decline in imports, and to higher exports. As the economy recovers with the relatively favorable outlook for new investments, imports may rise faster than projected by the staff. While I agree that export performance will continue to be favorable, it is dependent on external factors. As market confidence and future resilience of the Mexican economy rests on strengthening the real sector and increasing the national savings rate, further improvement of the balance of payments should reflect this fundamental strength of the economy. Improvements of international reserves that are not derived from real productive capacity, and investment flows to create future export production, would still make the situation fragile. In addition, the banking system may take some time to recover. In this scenario, while we can share the confidence of the Mexican authorities that new purchases under the stand-by arrangement may not be necessary after August, I would recommend a more cautious approach in Fund advice on early repurchases. In view of the existing downside risks, early repurchases should be considered only if the reserves position were to remain consistently high over a relatively longer period.

I notice from the staff report and Mr. Guzmán-Calafell's statement that the authorities have introduced forward foreign exchange contracts and peso future contracts to hedge exchange risks. While I understand that the objective is to reduce uncertainties and improve market efficiency, I wonder whether a more gradual approach might be more appropriate. My concern is that such hedging mechanisms might inadvertently lead to more speculative activities and undermine the stability of the peso. To avoid this, would it not be more appropriate at this initial stage to limit such hedging facilities to trade and investment-related transactions only. I would appreciate staff comments on this.

On measures to revive the banking sector, I wonder whether the staff could comment on the loan restructuring scheme denominated in units which are indexed to consumer prices. As we generally disfavor inflation-indexed strategies, I wonder whether this scheme may disguise the severity of the nonperforming loan issue.

In closing, I would like to comment on the interesting background paper for the current discussion. This paper provides a useful record of the factors behind the Mexican crisis, as well as the three views on how and why the crisis happened. However, the staff appears to have underestimated the role of one important factor, namely, capital flows. Previous discussions at this Board and market analysts did conclude that it was the overreliance on short-term capital inflows to finance an inherently unsustainable current account deficit that precipitated the Mexican difficulties. As shown in Table 15 of the background paper, 75 percent of the capital inflows to Mexico during the period 1990-93 were in the form of short-term capital and portfolio investment. In contrast, the average for developing countries as a whole was 48 percent, while in Asia the comparative figure was only 25 percent. Considering that such capital inflows are inherently volatile and subject to sudden and sharp gyrations, Mexico's dependence on such inflows to finance its current account deficit actually compounded an already unsustainable situation.

Clearly, there are important lessons to be drawn from all this, and I would urge the staff to conduct more detailed cross-country analysis and research on the merits and demerits of reliance on short-term capital inflows vis-à-vis more permanent forms of financing for the current account deficit. Such studies should also focus on evaluation of reserves position to determine the underlying strength, which can differ when there are large financial flows vis-à-vis inflows that are more reflective of real growth in the economy. In this regard, the standard measurement of reserves adequacy in terms of months of retained imports should be complemented by other appropriate indicators, in view of the present situation in which economic growth in developing countries are occurring amidst more open trade and financial services regimes.

Ms. Lissakers made the following statement:

Mexico has made very impressive progress under its adjustment program. Of central importance, confidence in the peso has been returning and the creditworthiness of Mexico has been rising in international markets. Since the March review, the exchange rate has settled in a narrow range. Large redemptions of tesobonos have taken place, with a growing share being settled in pesos. Commercial banks have found it easier to renew dollar lines of credit, and thus to repay advances from official sources. Prime Mexican borrowers are beginning to re-enter the international credit markets. Net international reserves have been rebuilt by approximately US$4 billion since the end of March. The current account deficit has been nearly eliminated, as a result of rapid export growth and compressed imports.

These results have been achieved through a very determined implementation of stringent fiscal and monetary policies. The fiscal targets of the stand-by arrangement have been met by a wide margin, despite the weakness of the economy. Tight monetary policy has contained the inflationary impact of currency depreciation and tax increases. After a peak of 7.9 percent in April, inflation was 4.2 percent in May, is likely to be about 3.5 percent in June, and is expected to be under 3.0 percent in July. The monetary base is MexN$12 billion below year-end levels and, in real terms has shrunk substantially. Very high nominal interest rates have trailed lower as inflation has dropped, but the stance of policy continues to be restrictive.

This is the sort of adjustment and commitment that justify the exceptional support provided under Mexico's stand-by arrangement. But although the financial fever has subsided, there are serious hazards still ahead. In July and August, Mexico faces a large bunching of maturing tesobonos that will strain its external resources. Going forward, policymakers face the delicate task of consolidating and sustaining the stabilization gains that have been achieved, while trying to position the economy for renewed growth.

I believe the arrangement that has been negotiated for the balance of the stand-by arrangement is properly structured to meet the requirements of the next 12 months. The agreement provides for drawings in six tranches subject to three reviews. The proposed tranching pattern reflects the progress achieved since the first of the year. Gradual disbursement of Fund resources is appropriate, in view of the much-reduced financial vulnerability of Mexico and given the large amounts already advanced. The risks of pressure on reserves will be greatest in July and August, when debt redemptions are largest. As indicated in the staff paper, under the terms of our bilateral agreement, the United States expects to provide another US$2-3 billion to Mexico during July. The undisbursed balance of the US$20 billion facility will remain available for use as needed. While we have every reason to believe upcoming tesobono redemptions will be handled smoothly, the supplement to reserves provided by Fund backstopping will help assure that this is the case. Thus, we believe that the size and close timing of the first two tranches are well matched to Mexico's needs.

The smaller, later tranches provide assurance to Mexico--and to the international creditor community--that Mexico will continue to have the financial support it needs to see its program through to completion. More important, the conditionality and the frequent reviews that go with these additional disbursements assure us that this program really will be driven home to the successful conclusion that now seems within grasp. A steady policy will be needed in the months ahead, even in the event that external financing requirements wane.

I welcome Mr. Guzmán-Calafell's statement that his authorities expect that no additional Fund resources will be required after August, as long as the present trends continue. The best way we can guarantee that these trends will indeed continue is for Mexico, on its part, to continue to implement rigorously its economic adjustment program, and for the Fund, on its part, to continue to be prepared to provide financial support for that program.

Extending her comments, Ms. Lissakers stated that the United States planned to disburse $2.5 billion in assistance to Mexico in early June 1995, pending the successful completion of the current review under the stand-by arrangement.

As to the scheduling of further disbursements of U.S. aid to Mexico, her authorities had, from the outset of the crisis, followed a practice of announcing disbursements as they were made, Ms. Lissakers recalled. That practice had allowed the United States to be flexible in providing assistance as, and when, it was most needed. As the U.S. Secretary of the Treasury had recently announced, the U.S. authorities intended to make the remainder of the $20 billion committed assistance available to Mexico on that basis. As Directors would recall, the United States had made disbursements of $10 billion, in addition to its participation in the Fund's support for Mexico, thus far. Her authorities would continue to stand by Mexico in its efforts to resolve the current financial crisis.

Mr. Kafka made the following statement:

> We fully support the staff's proposals for substantive waivers of two performance criteria for June--net domestic assets and net international reserves--and for the full amount of augmentation foreseen, as well as the conclusion of the review. We cannot support either of the two alternatives proposed by eight Executive Directors in their memorandum of June 28. The Mexican problem is essentially a liquidity problem, particularly significant in July-August. It is a problem that is very sensitive to the perceptions being formed by the market. It is, therefore, appropriate for the Fund to advance to July-August, and not to question for the future the availability of Fund and other resources to Mexico. The proposal of the eight Executive Directors would be counterproductive, because it could cast doubt on Mexico's expected performance, rather than on its expected need. As to its expected performance, Mexico's policies have already led to significant and steady improvements.
>
> On fiscal matters, it is encouraging that the Mexican authorities have appointed a tax reform commission, whose proposals are to be submitted to Congress by September. We would hope that the Board could be kept informed of the progress of the commission's work, and we are encouraged by the fact that Mexico has requested the technical assistance of the Fund for the work of the commission.
>
> On monetary policy, we note the staff's estimate of the extent to which the tighter than originally foreseen monetary policy over the rest of this year would impact on the fiscal outturn, but we are reassured by the compensatory measures mentioned by the staff.
>
> On the exchange rate regime, we fully support the retention of a floating rate bolstered by the tighter financial policies

that have already been mentioned. We welcome the establishment of peso futures contracts.

On trade policies, we welcome the conclusion and proposed establishment of various free trade arrangements between Mexico and other countries in Latin America. We note with understanding the increase, in early May, of import tariffs on products similar to those produced by certain domestic industries that have faced difficulties as a result of earlier tariff reductions and the devaluation of the peso. It is understandable also that no date should have been set for the prospective rollback of these measures. It would be impossible to foresee when such a rollback would be appropriate under the present uncertain conditions.

It is encouraging that Mexico, along with other Latin American countries, is returning to the international capital market, at least in a modest way. It is of concern, however, that capital goods imports are expected to fall by as much as 36 percent during this year.

It was welcome to read in the staff report about the action taken by the authorities and proposed to be taken regarding privatization, deregulation, and widening the scope for foreign investment. The changes foreseen in the character of social expenditure are also commendable.

The Mexican authorities have taken rapid and effective action to contain the financial crisis that has affected the financial system subsequent to the devaluation. We expect that these measures will prove adequate and see no need at the moment to inquire into contingencies.

In the medium term, the outlook for the success of the Mexican program will be bolstered by the proposed tax reform and by the reform of public expenditure controls; the maintenance of a floating rate should assure an external current account deficit no larger than can be financed over the medium term. Capital inflows, essentially private, are expected to average US$10 billion a year, more than enough to cover the current account deficit and to permit the accumulation of reserves. In these circumstances, there would be no question that Mexico's debt to the Fund can be repaid.

In sum, while there may be many uncertainties, there are enough encouraging features in the Mexican situation. We must give Mexico the benefit of our confidence and wish the Mexican authorities the best of luck.

Mr. Shaalan made the following statement:

The financial markets' positive reaction to the marked strengthening of Mexico's demand management policies and the clarification of financing arrangements since early March of this year are most encouraging. The strengthening of the peso, the decline in interest rate spreads, and the stock market recovery would all seem to indicate that a major corner has been turned in the effort to stabilize the Mexican economy and place it on a path of sustainable growth. This said, it would obviously be premature to declare victory, as significant risks and challenges still lie ahead. However, we are highly impressed by the courage and determination with which Mexico has pursued its adjustment objectives. The authorities' strong policy performance so far under the stand-by arrangement, and their policy intentions for the period ahead, provide a solid basis for optimism regarding the country's ability to overcome its economic and financial difficulties. The Fund's continued strong support is clearly of paramount importance to the success of Mexico's adjustment effort. I would add that I find the request for waivers to be well justified. I also consider that the proposed phasing of the remaining purchases under the arrangement to be appropriate. Accordingly, I fully support the proposed decision.

As regards the risks and challenges that still lie ahead, I broadly agree with the staff's overall assessment of these risks and challenges. I particularly agree that a further substantial deterioration of commercial banks' portfolios, and the possible reversal in market sentiment that could result from the absence of sufficient financing to cover the large stock of maturing tesobonos over the next two months, represent very serious risks. Approval of the proposed phasing of the remaining purchases under the stand-by arrangement would go a long way toward reducing the latter risk and dispelling any doubt regarding the availability of Fund purchases after August. In this context, I am quite content with the Mexican authorities' reaffirmation of their intention to forgo some purchases from the Fund in the event that the economic situation stabilizes, and to make early repurchases to the Fund if reserves permit. To try to do more by formalizing this intention as a mutual understanding or an explicit expectation would, I am afraid, risk precipitating a measure of uncertainty that Mexico can ill afford at this stage.

It follows that I do not favor either of the two formulations proposed by the group of eight Directors. Leaving open the scheduling of purchases for the period beyond August, as called for under the first formulation, would introduce an element of uncertainty that we can well do without. The fact that the performance criteria have not been specified for 1996 does not provide a justification for not deciding on the phasing right now, for we do that all the time in the context of multiyear arrangements, wherein phasing is determined at the outset, but performance criteria are specified, at most, for the first full year of the arrangement.

As regards the second formulation, which seems to be thought of as the milder of the two, let me say that I find that formulation to be at least as problematic. If my reading of it is correct, that formulation comes very close to interfering with the sacrosanct principle of "automaticity of purchases" under a stand-by arrangement once the arrangement has been approved. As Mr. Berrizbeitia and Mr. Guzmán-Calafell have indicated in a memorandum to Executive Directors, 1/ the Fund may not challenge a member's representation of need made in the context of a purchase under a stand-by arrangement or an extended arrangement. Thus, if all the conditions prescribed under the arrangement have been met, the Fund must meet the purchase request. To the extent all of this is true--and I believe it is--what is the point of trying to establish a presumption that the arrangement would become precautionary after August? I submit that such a presumption is unenforceable because enforcing it would be at variance with the legal framework that governs stand-by arrangements. Therefore, I consider that including in the summing up language along the lines of the second formulation can only introduce doubts and uncertainties, something we should do our utmost to avoid.

With regard to the challenges that still lie ahead, the sociopolitical sustainability of the adjustment effort is another key challenge facing the Mexican authorities. The dramatic reorientation of resources away from domestic absorption, which is evidenced by the sharp decline in the current account deficit to a projected 0.9 percent of GDP in 1995 from about 8 percent in 1994, has unquestionably hit hard a large segment of the population. The recorded rise in measured unemployment vastly understates the extent of the hardship. In these circumstances, the continued adequacy of the Government's social safety net program would need to be closely monitored and assured. In this connection, I would add that high priority should be accorded to stepping up social spending, with a view to making up for the shortfall in this expenditure category during the first quarter of this year.

1/ See Attachment III.

Finally, with regard to the medium-term outlook, I note that the external current account deficit is projected to stabilize at about 2 percent of GDP, a level considered by the staff to be sustainable over the medium term. In principle, this is not a conclusion that I would necessarily find too difficult to accept. But, I believe the sustainability of the current account position should receive further careful analysis, and I hope it will be possible to have this matter elaborated on further in the context of future staff work on Mexico.

Mr. Autheman made the following statement:

I share the staff's appraisal that the general macroeconomic framework of the program continues to be valid; and, like previous speakers, we are impressed by the performance of the Mexican authorities in implementing this program. We are concerned about the probable continuation of a recession; but we very much welcome the consistency of the Mexican authorities' commitment to their stabilization efforts.

We, of course, regret that the performance criterion for net international reserves at the end of June was not met; but we are pleased to see that the orderly reversal we were looking for at the end of March has been achieved. Therefore, we agree to grant the waiver requested.

Let me turn to one substantive issue, which is our decision. I am grateful to Mr. Berrizbeitia for his written answer to the memorandum sent by several Directors, including me. My understanding is that we need at this stage to confirm the availability of our commitment. There is no doubt about that. No member country has expressed reservations on this issue, and thus I am puzzled that the suggestion to amend the decision would be interpreted as casting doubt on this availability. The Fund membership, as on several previous occasions, expressed its commitment; never in the past have Fund members drawn back from commitments.

The second important element is to maintain the proper conditionality so as to support the Mexican authorities' adjustment efforts. In this regard, I agree with Ms. Lissakers that the existence of the scheduled drawings for the end of 1995 are part of this conditionality. However, the last two drawings envisaged are basically unconditional, as they rely on no agreed fiscal or monetary program for 1996.

The final element is the need to show some confidence. We are no longer in crisis management, and we need to move toward confidence building. We have good reason to expect that the final outcome of this adjustment program can be successful, and we must find a way to convey these two messages: the message that our support remains available; and the message that we are confident that Mexico's efforts will be rewarded with success.

A proper way to express such confidence would be to indicate that at this stage we think that Mexico needs Fund resources for this summer, considering the nervousness of the markets regarding the redemption of tesobonos. But, based on both the turnaround of the current account and the commitment of the authorities to sound fiscal and monetary policy, we do not expect further trouble in the external position of Mexico.

We also have a legal objection, which relates to sacrosanct automaticity, to quote Mr. Shaalan. If automaticity were sacrosanct, we would have never entered an exceptional arrangement. We would have complied with the sacrosanct access limits.

I recall that the issue we are raising today was discussed at the time of our February discussion, and in a carefully worded sentence, the Director of Policy Development and Review Department "agreed that there would need to be an assessment of Mexico's balance of payments need in determining the augmentation of the arrangement or in approving the move to an extended arrangement. That assessment would be a function of the resources otherwise available to the country."

Therefore, I think that the question that several of us have raised is fully legitimate and consistent with the spirit of our February discussion; and I would be reluctant to have a sacrosanct principle opposed to a legitimate discussion of what is the appropriate handling of an exceptional situation.

Is there a risk that such an approach might be damaging to Mexico? Is there a greater risk that an approach similar to the one followed by the U.S. authorities might be damaging to Mexico? The markets' concerns, in my view, are related more to domestic political pressure in the U.S., which create an uncertainty on future disbursements, than to the unwillingness of Fund members to act according to their commitments. And I find it very difficult to object on the grounds that such an approach would create major uncertainty in the case of the Fund, while creating no uncertainty in the case of the United States.

Should the Fund remain silent on an issue addressed publicly by the Mexican authorities? The Minister of Finance was correct to indicate publicly that he expects that he will be able, by strictly implementing the program he has agreed upon, to forgo some purchases. Should we remain silent on the grounds that if we said something we would cast a doubt on the strength of our support?

In my view, the major risk would be in creating a situation whereby, by not being explicit on the substance of our agreement, we could create the risk of disharmony among Fund members, between the U.S. and other shareholders, and between some members of the Fund and the Mexican authorities.

While I am realistic, I do not expect unanimous support for a different decision, which I regret, and which means that we need to be more cautious in the future, when we will be asked to act under exceptional circumstances. But I fail to understand why the Fund would not explicitly state under what understanding it agrees to make available its full support. And I hope that we will be able to at least agree on a very strong and explicit summing up, stating that we will continue to carefully consider the exact extent of the balance of payments need of Mexico for each purchase after August, and that we presume that beyond August, and as long as the program is well implemented, the arrangement will be of a precautionary nature and Mexico will be able to forgo future purchases.

We should not forget that what is asked, in this present decision, of several Fund members is to draw on their reserves in order to provide exceptional support above Fund limits to a country in need. There is no doubt about the availability, but I think it would be regrettable if we could not reach an agreement stating our current understanding of how this exceptional arrangement will develop.

Mr. Shaalan commented that, although Mr. Autheman and other Directors were correct to note that no performance criteria had yet been set for 1996, Fund-supported programs frequently did not specify performance criteria beyond the first year of an arrangement. That should not preclude the Board from taking a decision on the phasing of future purchases for the current discussion. Indeed, the establishment of specific performance criteria for 1996 should be taken up as a separate issue.

Ms. Lissakers noted that the United States' extraordinarily large commitment of assistance to Mexico had been controversial from the outset. Indeed, that commitment had been the subject of virulent attack from a number of political groups in the United States. Nevertheless, the Administration had fulfilled its commitments to date. It was important to bear in mind that the United States' financial support for Mexico was intended to serve a different purpose from that the Fund; thus, it followed a different pattern of disbursements. It would be important for the Fund, in the context of the decision taken for the current discussion, to send a clear signal that it would continue to act in accordance with its past practices in order to provide assurances to all parties that adequate financing would continue to be available to Mexico on an appropriate basis.

Mr. Zhang made the following statement:

The Mexican authorities are to be commended for the progress they have made in carrying out their comprehensive economic program and improving financial stability. It is encouraging to see the preliminary results on the external and fiscal accounts, reflected in the sharp reduction of trade imbalances and the larger than projected primary and overall fiscal surpluses in the first quarter of this year. In the meantime, the exchange rate of the peso has improved substantially, and Mexico has been able to gradually return to the international capital markets. It is acknowledged that the strong support from the international community has assisted the authorities in overcoming the crisis. However, much remains to be done. In particular, the serious risks facing the banking sector and higher budgetary interest payment requirements, as reflected in the nonobservance of the performance criteria, deserve greater vigilance and policy adjustments on the part of the authorities. I broadly agree with the staff on the thrust of its report and, therefore, would like to make a few comments on monetary, fiscal, and trade policies, for emphasis.

The authorities' tightening of monetary policy has made a positive contribution toward the development of the financial sector. The decline of the interbank interest rate and subsequent recovery of the financial market reflect improved confidence. In this regard, I would like to stress the significance of the central bank's adhering to the restrictive monetary policy stance, in spite of its obligation to foster the banking system in the current circumstances. Efforts to rescue the problem banks should not be exercised at the expense of relaxing financial discipline. It is important for the central bank authorities to prevent any loosening from the control of monetary aggregates in view of the inflation rate, which--although subdued--is still one of the major risks to the authorities' stabilizing efforts.

With regard to fiscal policy, although positive developments could be seen in the fiscal accounts during the first months of the year, the substantial need for budgetary expenditure in the near future spares no room for relaxation. As an increase in interest payments is expected for the rest of the year, further improvement in tax collection and administration, as well as an accumulation of budgetary surplus, will be desirable. The possible fiscal cost of the restructuring of the banking system poses a further risk for the budgetary balances as well as a need for continued restraints on current expenditures for the next few years. The authorities are encouraged to make a concerted effort to strengthen their fiscal management program as a sound base for cautionary monetary and external policies.

With regard to trade policy, while it is noted that the Mexican authorities have been committed to adhering to the principle of an open trading system, and some advances have been recorded with several new regional free trade agreements, the recent introduction of a very high rate of import tariffs on certain goods represents an unfortunate setback. I would like to join the staff in urging the Mexican authorities to eliminate these measures as soon as possible.

In conclusion, I am convinced that it is extremely important, at the moment, to foster market confidence in the Mexican program by committing to the availability of sufficient international financing. In this context, I fully share the authorities' view, as expressed in Mr. Guzmán-Calafell's statement that "successfully overcoming this challenge would not be possible in the absence of adequate external financing." A strong assurance of firm support from international institutions is indispensable for the future success of the Mexican adjustment program. As emphasized in Mrs. Cheong's statement, "to do anything less would run the risk of undermining market confidence in Mexico." Therefore, I support the proposed decision.

Mr. Clark made the following statement:

In our first review of the stand-by arrangement for Mexico in March, this Board reminded the authorities that policy credibility depended critically on clear statements of policy intent followed by consistent action in a broad domain of policies. The Mexican authorities apparently subscribe to this proposition judging from their actions in the last few months. Notable in this context are: the authorities' strenuous efforts, to better the fiscal policy targets of the program; their reaffirmation of a flexible exchange rate regime and the corresponding absence of significant market intervention since March; the determined follow-through in the past months on financial sector reforms aimed at strengthening the extremely fragile and vulnerable banking sector; and, the development by the Bank of Mexico of the IBAMEX system, an economic information bulletin board that includes a comprehensive economic and financial data base system, which is now available for selected users (including the Fund) and soon to be available to the general public.

My advisor attended the recent briefing by the Bank of Mexico and was very impressed.

The success of the Mexican authorities to date in moving their economic policies toward a more sustainable growth equilibrium is undeniable and indicative of their determination. Of course, the reform process must continue and there are still some policy and program risks that should be addressed as quickly as possible to avoid potential adverse shocks to economic growth and policy credibility in the future.

I would like to offer a few remarks on policy issues and on the design of the Fund program.

With regard to fiscal policy, the preliminary data on the fiscal deficit indicates that the program target for March was exceeded by 1.3 percentage points of GDP. While about one-half of this gain is related to better than expected tax revenues and public enterprise profits, the other half was associated with the delayed implementation of negotiated wage increases and programmed social expenditures. These gains are not sustainable unless they are the consequence of more permanent and fundamental program reform.

It may, in fact, be necessary to reform some public spending programs and to renegotiate public sector wages to achieve the fiscal targets of the program or to remain within the liquidity constraints imposed on the government by markets, but this should be completed in a transparent and credible fashion. This would allow the recipients the opportunity to adjust their consumption patterns to the new economic realities in an efficient manner. Expenditure delays aimed at lowering government cash requirements on a one-off basis only postpone required adjustments by all involved and often add to ultimate adjustment cost.

Indeed, the staff report indicates that the authorities have begun to work off these obligations by retroactive payment in wages and by accelerating the delivery of social services to the eligible recipients.

Considering how difficult the economic adjustment will be for many, it is encouraging to note that the authorities are investing in programs to improve the educational and training opportunities for individuals and their access to basic nutrition and health care. However, targeting these programs to those in critical need will be a challenge that must be undertaken.

The sharp reduction in the level and growth of income projected over the short-term is expected to sharply reduce the flow of domestic saving, forcing the public sector to increase its reliance on foreign debt under the program. The ceilings on the growth of net domestic assets, which are at least directionally consistent with reduced domestic saving, drop the domestic debt-to-GDP ratio of the non-financial public sector to 10 percent by year-end (less than one-half its level at the end of 1994) while increasing the external debt-to-GDP ratio to 26 percent from 19 percent. The staff's medium-term projections indicate that despite an overall decline in the overall debt-to-GDP ratio from its inflated level at the end of 1995, this skew away from domestic debt to external debt will remain.

Even granting that much of this debt is derived from the emergency financial package and has a longer maturity structure than in the past, external debt has already proven to be troublesome for this economy. The authorities could consider taking steps to encourage growth in domestic saving - particularly private saving given the strong fiscal consolidation program already in place - in order to accelerate the paydown of external debt. For example, tax reform with greater emphasis on consumption taxes and savings incentives may be useful in this regard.

In regard to trade policy, the recent initiatives of the Mexican authorities to develop further their bilateral free trade association with other countries in the region and their preferential trade arrangement with MERCUSOR is a sound strategy for expanding external trade beyond the NAFTA base. However, the protective tariff increases imposed last month on specific manufactured goods--notably footwear and clothing--can quickly become counterproductive, even though they may be within the bounds of the requirements for WTO membership.

With shrinking domestic demand, the apparent objective of the tariff increases is to protect the production levels of domestic firms by insulating them from competition with low-cost foreign producers. This strategy can easily offset the competitive gains associated with the real exchange rate depreciation by supporting resource misallocation and by imposing higher product prices on consumers already struggling with real income losses. Moreover, it raises questions regarding the credibility of the authorities' professed commitment to free trade and industrial restructuring.

On financial policy, the authorities have initiated a number of policy changes to strengthen the financial integrity and the operating capacity of the Mexican banking system. Among the most notable recent initiatives is the relaxation of restrictions on the entry of foreign banks and on their ownership share of domestic Mexican banks. This policy action should stimulate the efficiency of the banking system by encouraging, over the medium-term, some financial recapitalization of the industry, technological improvements, and increases in the human capital investment. Earlier initiatives to liberalize the banking industry have already begun to pay some positive dividends with the introduction of new products such as forward currency contracts that help manage the risks associated with more flexible exchange rates.

However, some of the other actions that proved necessary in the short-term to prevent the collapse of the banking system in the wake of the financial crisis may require some restructuring to avoid longer-term inefficiencies. The authorities have, for example, fully guaranteed deposit investments in Mexican banks and have undertaken bond-for-loan swaps with the banks to replace non-performing loans in their portfolios with government securities. The moral hazard risks associated with these schemes can weaken the long-term viability of the banking system despite the initiatives to improve monitoring and supervision. This issue becomes even more critical with the prospect that a couple of other banks may soon find themselves facing the prospect of insolvency. The approach that the authorities decide to take can illustrate their commitment to market discipline and efficiency in the banking sector, particularly if there is little systemic threat to the banking sector of subsequent bank failures. The authorities may wish, therefore, to revisit some of these programs in conjunction with the technical assistance currently underway from the World Bank and the IDB.

As to the design of the Fund program, on monetary policy targets, in the first review of the stand-by arrangement, the Board waived the deviations from the monetary targets for net domestic assets and net international reserves because of the authorities' need to finance the large redemptions of maturing tesobonos with central bank credit. Even though the authorities have sharply reduced the overrun in net domestic credit of the central bank and the deficiency in net international reserves relative to the target levels for June, once again the Board must waive deviations from these targets. Moreover, with the generous profile that the authorities have set for themselves on these variables for July, the prospect of meeting the September targets, in terms of either changes or levels, seems quite remote.

Since the original targets have proven themselves to be unachievable over the first half of the year, could the staff recommend more realistic targets to avoid repeating this waiver procedure in September and December? I hasten to add that this is not meant to imply that a relaxation in future monetary conditions is required, but only that the December 1994 base conditions and presumed credit requirements for the original monetary targets appear to have been inappropriate in light of the subsequent adjustment in financial conditions.

On the disbursement profile, in reference to the alternative proposals by a group of Executive Directors for disbursement of these funds and review of the Fund's resource commitment at some future date, we are unconvinced of their merit relative to the staff proposal. The first option is unacceptable since we have already agreed to commit the resources on the basis of existing and prospective need and have no grounds at this point the review that decision or reasoning. The second option seems more reasonable but unnecessary in light of Mexico's re-affirmation in its letter of intent that purchases would be foregone in the absence of need, and of the Board's discussion on precautionary arrangements last January where the issue of need was reviewed. At that discussion, it was noted in the supporting documentation that existing need was a requirement for any purchase under a stand-by arrangement that had already been approved. If the Fund determined that no existing need was evident for a purchase, it could take remedial action to restrict the member's use of the Fund's resources that would effectively block the purchase. Since this procedure has been determined elsewhere, there is no purpose in reiterating it in Mexico's stand-by arrangement

There is also the issue of firmly signaling the Fund's confidence in the program and policy commitment of the Mexican authorities. Any hesitancy on the part of the Fund may be perceived as concern over the policy direction of the authorities, even when none truly exists, with consequent damage to the market's confidence in potential success of the program. Indeed, I am tempted to propose a third option. Facing a well documented liquidity demand in July and August, the Fund could signal its confidence in the viability of the economic program and the commitment of the policy authorities to achieve success even more strongly by altering the distribution schedule by increasing the front-loading. However, since I doubt I could persuade some of my colleagues to support this third alternative, this chair supports the decision as proposed in the staff report, and wish the authorities every success in their program.

Mr. Schoenberg made the following statement:

As one of the many fans of Mexico that were mentioned earlier, I very much welcome the fact that the adjustment efforts initiated by the Mexican authorities and supported by the Fund have quickly produced tangible results. The devaluation of the peso has led to a remarkable turnaround in the trade balance. We are also encouraged by the signs of a return of financial market confidence, and by the fact that the evolution of the public finances has been better than originally programmed. Obviously, however, the economic situation still remains fragile and continues to entail considerable risks, in particular, with regard to the situation of the banking sector.

We have the impression that the program, as designed through the end of 1995, properly addresses the most pressing problems. However, as the proposed decision to be taken today covers the program period until August 1996, including the tranching of the disbursements in 1996, we would have preferred a more detailed presentation of the economic program for 1996, including the definition of performance criteria for 1996.

The staff's proposals also suggest that the Fund is expected to demonstrate an extraordinary amount of flexibility in its reactions to the needs of Mexico, as illustrated particularly by the proposed handling of the performance criteria and the phasing of future disbursements. The newly introduced performance criteria for July for net domestic assets and net exchange reserves will allow Mexico to make further purchases in spite of the nonobservance of the original performance criteria under the program, while the proposed phasing for these purchases and the front-loading implicitly established by the phasing are geared to the short-term financing needs resulting from the redemption of maturing tesobonos. In displaying such "flexibility," the Fund runs considerable risks, for instance, of establishing new precedents and undermining the confidence of Fund creditors. In any case, our preparedness to accept the proposed phasing of future purchases would be considerably facilitated if we obtained satisfactory assurances that a comparable pattern of disbursements was scheduled for the remaining US$10 billion in bilateral assistance from the United States. I share Mrs. Cheong's assessment that a clear schedule of Exchange Stabilization Fund disbursements would go a long way toward allaying market concerns over the adequacy of financing resources to cover maturing tesobonos. I would appreciate it, therefore if the staff and Ms. Lissakers would comment on that question. I appreciate the fact that Ms. Lissakers has provided some information on that issue in her statement; however, I would welcome an additional comment on the availability of financing from the Exchange Stabilization Fund beyond July.

Although I can support in principle Mexico's request for the necessary waivers for the completion of the second review under the stand-by arrangement, this chair would favor a modified Board decision along the lines outlined as the "first alternative" in the memorandum, dated June 28, of a number of Executive Directors. According to the proposed modification, the Board would schedule the next two purchases in July and August, as proposed by the staff, while leaving the scheduling of additional purchases for further reviews. The reasons for that proposal, in addition to those extended in detail by Mr. Autheman, are as follows.

The stated purpose of the rescue operation in favor of Mexico, and for the unprecedented volume of financial assistance, was to prevent a systemic crisis. There are no signs of such a crisis, nor is there any indication of an imminent flare-up of financial distress in Mexico itself.

The adjustment of the Mexican economy is proceeding encouragingly and the Mexican authorities have therefore--quite appropriately--stated repeatedly, as on the occasion of the previous Interim Committee meeting, that Mexico may not need to draw all the resources committed by the Fund.

Ms. Lissakers has also provided good arguments in favor of a "one-time" approach and I tend to believe that what is good for the United States in this case may be also good for the Fund. I would also like to stress that, under the proposed modified decision, the Fund would be still more specific than would the United States in stating how much it would disburse if certain conditions were met.

One area of particular concern is the fact that the financial crisis that accompanied the sharp depreciation of the peso earlier this year is having a considerable impact on Mexico's banking sector, which is reflected in the deterioration of the bank's loan portfolios and in losses in dollar-denominated liabilities. We welcome the Government's efforts, supported financially and technically by other international institutions, to prevent an imminent collapse and to restructure the banking sector. From these efforts, however, we would expect considerable, although still unspecifiable, risks to the budget in the coming years. The staff has made useful attempts in its background paper to estimate the total costs of a restructuring program, ranging from 19 billion to 32 billion pesos. I understand from the staff report that no cash payments are scheduled for this purpose for the immediate future, with the first bonds maturing only in five years' time. However, there are clearly immediate opportunity costs involved for the Government in the short run, as the issuance of bonds to replace problem loans constitutes an increase in public debt.

There appears to be also a widespread uneasiness among financial market participants that the Mexican Government could be trying, together with state and private banks, to keep interest rates artificially low in order to reduce the fall-out from the banking crisis. An article in the Wall Street Journal dated June 19, 1995 also asserts that there are financial market concerns about the quality and quantity of information flowing out of Mexico with respect to developments in the Mexican banking system, and in particular, with respect to the so-called development banks. Perhaps the staff or Mr. Guzmán-Calafell could comment.

Like the staff we consider the recent increase of import tariffs on textiles and footwear an inappropriate measure. In fact, that kind of reaction was supposed to be avoided by putting together the rescue package in favor of Mexico. We urge the authorities to revise these measures as soon as possible. Unfortunately, the staff does not comment on the obvious question of whether the increase in import tariffs constitutes a violation of the stand-by arrangement approved on February 1. The arrangement specifies, under paragraph 3(d)(iv), that Mexico will not make purchases under the program "if at any time during the period of the stand-by arrangement Mexico imposes or intensifies import restrictions for balance of payments reasons." We wonder whether an additional waiver might be needed.

Finally, the staff notes that Mexico did not make use of the resources of the Bank for International Settlements (BIS) because of the conditions applied to this financing line. In my view, the implicit criticism referring to the financing arrangements with the BIS is superfluous. Quite apart from the fact that Mexico has just asked for an extension of the arrangements until September 1, 1995, anyone familiar with central bank procedures regarding bridging operations must know that expectations that central banks could lend medium-term money, preferably without adequate safeguards, are just unrealistic.

Ms. Lissakers said that the U.S. authorities did not intend to make disbursements of aid according to a pre-established timetable, because they wished to retain sufficient flexibility to provide assistance when it was most needed. The U.S. authorities and the Mexican authorities considered that the current arrangement had served Mexico well in its efforts to regain economic stability. Under the commitment made by the U.S. authorities, additional financial assistance of up to $10 billion would remain available to Mexico based on its compliance with the agreement reached in February 1995.

Mr. Guzmán-Calafell stated that the Mexican authorities had chosen to reactivate the agreement with the BIS, owing to concerns about possible negative market reactions to the large tesobonos amortizations falling due in July and August 1996. That action had been taken to avoid any re-emergence of market uncertainty. Mexico did not intend to make use of the credit extended by the BIS.

Mrs. Cheong commented that it would have been helpful if the United States had made a clear commitment to make disbursements of promised aid according to an established timetable. In the absence of such a commitment from the United States, it would be difficult to prejudge how the markets might react to an announcement by the Fund that Mexico would no longer have a balance of payments need beyond August 1995 and further disbursements by the Fund would be subject to review. The markets might perceive such an announcement as an indication that the Fund wanted to impose stronger conditionality or that the program was not proceeding as expected, despite recent announcements by the Mexican Government.

In the circumstances, it might be appropriate to leave it to the Mexican authorities to announce their intention to voluntarily forgo further purchases from the Fund beyond August 1995, Mrs. Cheong suggested. The market reaction to such an announcement by Mexico might be more positive, and the result would be the same in terms of the actual drawings made on the Fund.

Although Mexico's balance of payments position had improved significantly, the banking system remained fragile, Mrs. Cheong noted. Foreign investors were still closely monitoring developments in the banking system, and any negative reaction on their part could adversely affect the future prospects of the balance of payments.

Ms. Lissakers remarked that she differed from Mrs. Cheong on whether it would have been preferable for the United States to have announced a firm timetable for disbursements of U.S. financial assistance. Such an announcement would have limited the flexibility retained for the use of such assistance, which was designed to counteract market uncertainties when they arose. Given the political circumstances in the United States, such an announcement might also have precluded the United States from making such assistance available when it was needed. Announcing a timetable for disbursements to Mexico at the present stage could give rise to a situation in which neither the Fund nor the United States would be in a position to help Mexico respond to sudden shifts in market sentiment.

The proposal to make purchases from the Fund beyond August 1995 subject to future reviews was surprising, Ms. Lissakers considered. Such action on the part of the Fund could increase the likelihood that future drawings would be needed by creating doubts about Mexico's expected performance as well as its likely financing needs. That would, in turn, cause the rate of rollover of claims falling due to decline, leaving a larger financing gap. The Fund stood to gain little--or nothing--from taking such a risk.

Mr. Schoenberg said that he welcomed the indication that the Mexican authorities considered the availability of credit from the BIS to be helpful, even though they had not made drawings on it.

While questions pertaining to market sentiment were always a matter of judgment, Mr. Schoenberg considered, an announcement by the Fund that the situation in Mexico had improved to the extent that only two more drawings on the Fund were likely to be necessary--although the total amount of access under the stand-by arrangement would remain available--would likely boost market confidence in Mexico's prospects.

The Chairman commented that, based on the sense of the current discussion, the Fund could make public its positive assessment of the situation in Mexico. However, at the present juncture, it would not be advisable to take chances with Mexico's still-fragile recovery.

Mr. Evans said that releasing a positive assessment of the situation in Mexico to the public would be important. It should be noted that both of the alternative proposals currently under consideration involved a reaffirmation that the total amount of access under the stand-by arrangement for Mexico would remain available. Indeed, the second alternative, which was to include in the summing up of the current discussion, an indication that, beyond 1995, the stand-by arrangement was likely to become precautionary, should reinforce such a positive assessment.

He wondered whether the recent press reports indicating that the rate of rollover of tesobonos had fallen sharply were accurate, Mr. Evans asked.

The Director of the Western Hemisphere Department responded that the turnover of tesobonos into local currency instruments had increased to about 50 percent in May and early June 1995. Although the rate of rollover had since fallen to about 25 percent over recent weeks, the amounts involved had been relatively small. Thus, it would not be appropriate to conclude that that trend was likely to continue into July.

Mr. Autheman recalled that when Argentina had unilaterally announced its intention not to make further drawings under its arrangement with the Fund in 1994, the markets had become uncertain about whether it would remain committed to the adjustment program supported by that arrangement and about whether the authorities would continue to work closely with the Fund. Based on that experience, it might be better for the Fund to work with the Mexican authorities in announcing that the stand-by arrangement was expected to become precautionary beyond August 1995, rather than waiting for the Mexican Government to make a unilateral announcement to that effect. Such joint action would avoid giving rise to questions about whether the authorities would continue to act in full agreement with the Fund.

Mr. Mirakhor noted that, as market agents were not a party to the current discussion, they might not fully understand the reasoning behind the alternative proposals under consideration. While the risks related to those proposals had been clearly described by Mrs. Cheong, he wondered what--if any--risks could be associated with the decision proposed by the staff.

Ms. Lissakers said that the alternative proposals put forward for the current discussion could give rise to the same kind of market reactions that had occurred in the case of Argentina. At the present stage, it would be premature to indicate that no further purchases under the stand-by arrangement would be necessary after August 1995. The full effects of the economic downturn were only beginning to fully pass through the economy, and they were likely to become increasingly severe over the coming year. In addition, the external position was still very fragile.

While it was to be hoped that the markets shared the Fund's optimistic assessment of the economic situation in Mexico, it would not be prudent to risk creating additional uncertainties, especially as any adverse reaction by the markets could rekindle the crisis, Ms. Lissakers considered.

Mr. Guzmán-Calafell recalled that, in the case of Argentina, the announcement that no further purchases would be made from the Fund had coincided with a relaxation of fiscal policies. It was the combination of those two developments that had given rise to market uncertainties about whether Argentina would remain committed to the Fund-supported program.

Although the economic reforms under way in Mexico were beginning to bear fruit, the situation remained fragile, and continued implementation of the program supported by the stand-by arrangement would clearly be necessary, Mr. Guzmán-Calafell said.

Mr. Saito made the following statement:

> At the outset, I would like to commend the Mexican authorities for their commitment to economic discipline and to free market policies in very difficult circumstances. I will discuss briefly some of the issues presented in the paper, in particular, those related to the banking system. In the first place, the severe recession affecting the Mexican economy should be a cause for concern. It impinges directly on the possibility of the real sector to replenish its working balances so as to be

able to meet its obligations to the financial system. It is clear that the positive effects of depreciation on production are being outweighed by the sharp reduction in domestic demand affecting both consumption and investment. National savings are therefore observing a marked increase, which should be maintained beyond the short term through appropriate fiscal and financial incentives. I welcome the projected reform of the tax system, which seems to be oriented in this direction. At the same time, I wonder whether the system of retirement savings introduced in mid-1992 is performing according to projections, or whether there is any room for improvement. Comments from the staff would be welcome.

On the fiscal front, the Mexican authorities have proven their commitment to macroeconomic discipline through prudent fiscal policy that produced a substantial surplus during the first quarter. Considering the importance of wages within non-interest expenditures, it is important in the future to avoid wage adjustments with a retroactive character such as the one granted in April. Indeed, I have noticed that the different projections presented in the paper for the fiscal outcome of 1995 do not contemplate any type of wage adjustment during the rest of the year, and I wonder how realistic that assumption is. Another area of concern is the possibly excessive compression of capital expenditures, which has already suffered a sharp reduction during the first quarter and is posed to be curtailed further if other expenditures, in particular interest payments, were to become larger than projected.

Regarding monetary policy, the paper notes that the demand for base money has been lower than projected, making it more difficult to attain the net international reserves and the inflation targets of the program. Interest rates will therefore remain high throughout the year. Although this seems a sensible policy response, I would caution that persistently high interest rates could reinforce the present recession and weaken the soundness of the financial system.

Regarding the financial system, what the staff paper indicates is that the Mexican authorities have prudently handled the situation, skillfully avoiding a major banking crisis. It is clear that the effectiveness of the many corrective measures implemented will depend to a large extent on a favorable development of the macroeconomic variables, including the prompt containment and reversal of the downturn in the economy.

The "flight-from-quality" phenomenon, in which deposits moved away from larger banks and were attracted by smaller banks that offered higher interest rates, raises important questions. In view of the government deposit guarantees existing in Mexico, care should be taken that a moral hazard situation is not created, both in relation to imprudent bank behavior and also in relation to excessive delays by the authorities in closing down an institution, knowing that it would be translated into immediate losses through the universal and cost-free guarantees offered. In this regard, we welcome the efforts being undertaken in the supervisory and regulatory sphere, in particular, loan restrictions to related enterprises.

The restructuring of bank loans according to the Unidades de Inversión system seems well conceived, and it would indeed provide debt relief to debtors burdened with very high nominal rates of interest, while limiting government involvement through the assignment of the credit risk to the banks. The final success of the measure depends on the underlying quality of those loans. If, as the background paper points out, they were basically sound, then there would be no problems. However, if the soundness of those loans were questionable, their restructuring might only postpone the outbreak of a crisis. Another point is that of incentives. As the background paper explains, debtors have an incentive to be in arrears, because of the low penalty rate that applies to loan defaults. I wonder how banks will eliminate this incentive and bring debtors into the Unidades de Inversión system. Apparently, the best deal for debtors is to remain in arrears for as long as possible, and then cancel the total amount of the credit. The staff's comments would be welcome.

Developments in the external front--which is where the crisis started--are quite promising. The reversal and magnitude of the trade balance is impressive, and the current account deficit will be reduced to a minimum amount. Net private capital outflows, in turn, will be much lower than originally projected, and the overall external payments will be balanced.

The sharp increase in investment in the tradables sector of the economy and the structural reforms undertaken in the past have translated into productivity gains and a diversification of the export base that are now even more evident, with the brisk response of exports to the downturn of domestic demand. Moreover, the gains in export competitiveness derived from the depreciation of the currency will depend, to a large extent, on the ability of the authorities to contain wage increases in the medium term, and to continue absorbing its social and political consequences.

The Mexican program is at a critical juncture. If the authorities were to get through the next two months without impairing Mexico's creditworthiness, and without further upsetting the foreign exchange market, it would be highly probable that a real take-off in confidence might occur. It is critical, therefore, that the authorities maintain strict monetary and fiscal discipline and that the external support already promised be timely and commensurate with expectations. However, once that policy responses have been chosen and implemented, and the first signs of success are seen, it would be regrettable if the participants' support were to be withdrawn at this point. Like Mrs. Cheong, I believe that any signal that access to Fund resources may in any way be impaired in the future would be interpreted negatively by the markets. Thus, it is vital that the proposed decision be approved as presented in the staff paper.

Mr. Kiekens made the following statement:

The tightening of fiscal and monetary policies since March 1995 has resulted in the reasonable stability of the exchange rate, a downward trend in inflation, a steady reduction of interest rates, and a major turnaround in the trade and current accounts.

The staff rightly discusses two major risks for the program: the availability of external reserves in the period ahead, and the health of the banking sector. I agree with the staff and Mr. Guzmán-Calafell that, in light of market volatility, it is important for the Fund to confirm that its strong financial support remains available as needed, provided Mexico is implementing the policies described in the program. I can therefore approve the proposed decision, including the request for waivers, but I have concerns about the policy program for 1996.

With respect to the alternative proposals put forward by my European colleagues and me, I see that there is already a sizable consensus about the second option, indeed.

I note that the Government and the Banco de Mexico reiterate, in their letter of June 20, 1995 to the Managing Director, "their intention to forgo some purchases from the Fund if the economic situation stabilizes, and to make early repurchases from the Fund if reserves permit." This "intention" is, however, a weakened confirmation of each member's commitment under the Articles of Agreement to use the Fund's resources only in cases of balance of payment needs. There can be no doubt that Mexico, irrespective of the apparently careful drafting of its "intention," is bound by this strict commitment. I join Ms. Lissakers and other speakers in welcoming the Mexican authorities' expectations that there will be no further purchases of Fund resources after the August 1995 drawing. I can subscribe to this expectation, or should I say "presumption," in the light of the forecast of a limited deficit of the current account for the remainder of the year, of the need to further increase Mexico's reserves by about US$3.4 billion, and of the prohibition--under Article VI--of the use of Fund resources to cover a large outflow of capital. I therefore presume--as, I note, do the Mexican authorities, Ms. Lissakers, and Mr. Clark--that the arrangement will become precautionary in nature after the August 1995 drawing.

At this stage, an understanding in the Board on an agreement with the Mexican authorities about how we would assess the criteria for balance of payments needs, in light of the projected developments in Mexico's economic situation, would be a strong source of guidance for the Mexican authorities and for the staff in determining whether the drawings are in accordance with the commitments under the Articles of Agreement. It also would make clear to the market that, if the Mexican authorities effectively forgo drawings in the future, this would not be a unilateral decision to escape further Fund conditionality, but rather implementation of the rules of the Fund.

With regard to the availability of support from the U.S. Treasury, I see merit in the flexible approach as described by Ms. Lissakers. The support by the U.S. Treasury clearly serves other purposes than does support by the Fund. But I would argue that it is difficult to accept that if we were to come to the conclusion that there is a need for Mexico to draw on the resources of the Fund, there would be no need for Mexico to draw support from the U.S. Treasury. The U.S. Treasury support is mainly to refinance capital outflows. The support by the Fund is mainly to bolster the current account position, and to build up reserves. Thus, as we have agreed that in July and August there will be a need for drawings, I would have liked to have heard confirmation from the U.S. Treasury that in July and August there would be a need for a drawing. Although I can understand that that commitment is not necessarily public, it could have been made in this Board.

The second issue on which I would like to comment is the policy measures to strengthen the fragile banking sector. The growth of Mexico's economy depends on sustained increases in aggregate investment. Inflows of external capital and the return of flight capital will play an important role, but experience shows that domestic savings make an even more critical contribution to the healthy development of an economy. The domestic financial markets are crucial in mobilizing these savings.

Mr. Guzmán-Calafell has listed various measures for addressing the weaknesses of the banking sector. These include more flexible rules, encouragement of foreign investment to recapitalize the banking industry, market-determined interest rates, and strengthening of banking supervision. All these measures are especially welcome, as is their financial support by the IADB and the World Bank.

The background document contains an estimate of the budgetary cost to support the Government's rehabilitation of the banking sector, as well as of its guarantee of all bank liabilities except subordinated debt. Despite the Unidades de Inversión scheme, the cost will still be between MexN$7 billion and MexN$14 billion, assuming a real interest rate on cetes of 5 percent. The sensitivity of this estimated cost to interest rate movements is great: a change of 1 percent in interest would almost double it. To this must be added the program for the purchase of bad loan portfolios, which could cost as much as MexN$6 billion. Nor should we forget the costs of reimbursing the IADB and World Bank loans, which will start affecting the budget in about five years.

I would like to mention three considerations here. First, it is important to forcefully restore confidence in the economy by implementing the program firmly, in order to minimize the costs of rehabilitating the banking sector. Second, although the estimated costs of assisting ailing banks seem sustainable in the medium term, its risks must also be kept firmly in mind. The need for caution is all the greater because Mexico's stronger than expected fiscal position in the first quarter of 1995 was, at least in part, due to the deferral of some spending and to higher than expected oil revenues. Prudence calls for accelerating privatization, the proceeds of which can be used to partly offset the cost of banking sector restructuring. Last, we should not underestimate the effort needed, whose costs will continue to burden Mexico for many years.

As regards the design of the program for 1996, during which two purchases are scheduled without further performance criteria, there is indeed a strong presumption that the program will be precautionary from August onward. However, this does not justify the absence of performance criteria for the two 1996 drawings. I am concerned about the absence in the staff report of indications about the course of the program after 1995. There are almost no projections for 1996; nor are there any indications about the policy intentions of the authorities. For example, the expectation that domestic savings are expected to increase sharply in 1995 and continue from 1996 onward is welcome, but the strategy that will transform it into reality is not clear. The report does not project the behavior of the real sector data beyond 1995, an omission that deprives the Board of any insight into how the growth objectives of 2 percent in 1996 and 5 percent during the next four years are to be achieved. Arguably, if Mexico were to survive the tight repayment schedule of tesobonos in July and August without major difficulties or adverse reactions from the financial markets, it would be reasonable to say that the financial part of the crisis is nearly over.

Unfortunately, the effects of the crisis on the real economy are more persistent, and the real economy's return to normal will take much longer. Among the effects on the real economy that are already visible, let me mention in particular: sharply reduced consumption; sharply reduced imports of both consumer and capital goods; a sizable rise in unemployment; and changes in the spending pattern of households, in particular, the increased consumption of goods with a low income elasticity of demand.

These changes will have significant effects on the business sector, including a short-term reduction of the profitability of enterprises as they adjust to the reduced volume and changed composition of demand. At the same time, the worsened financial situation of enterprises is already affecting the quality of the banking sector's loan portfolios.

All this adds to my discomfort, because it seems to me that the considerable resources that the Fund devoted to Mexico ought to be protected by sound policies not only during 1995, but also throughout the entire repayment period.

An additional risk to the medium-term projections stems from the observed sensitivity of exchange rate movements to changes in Treasury bond yields. During recent weeks, the peso exchange rate depreciated in response to reductions in interest rates that took place during the auctions, and I would be interested to learn whether the staff still considers Mexico's exchange and interest rates to be compatible.

The alternative scenarios in Table 14 of the staff paper show the sensitivity of the current account and reserves to changes in assumptions about the variables that affect them. As some of these variables lie outside the control of the Mexican authorities, it would seem desirable to devise some contingency measures in case the adverse assumptions materialize.

Contrary to the intentions expressed in January, the authorities have increased import tariffs on textile and footwear. On this issue, I share Mr. Schoenberg's concern. This measure is not only surprising in view of the devaluation of the peso, but also is extremely counterproductive in terms of Mexico's international financial support, as the main purpose of providing this support was to enable Mexico to preserve the existing degree of freedom in its trade regime.

Finally, the Mexican authorities are to be commended for improving their provision of data to the Fund and to the public, and I welcome the launching of the IBAMEX project, which will be available on the Internet.

I agree with Secretary Rubin's statement of yesterday that "Mexico's economic reforms have borne fruit." The situation is still fragile, however, and a continued determined implementation of the program is necessary. This is why the Fund also needs to continue supporting Mexico as needed.

The Director of the Western Hemisphere Department noted that the setting of the performance criteria for net international reserves and the net domestic assets of the Bank of Mexico for September and December 1995 had entailed risks, to the extent that the achievement of those targets would depend on the performance of the markets. While setting performance criteria for net international reserves and net domestic assets almost always entailed some risk, the staff and the authorities had considered it appropriate to set ambitious targets in the current circumstances of Mexico. The means to attain the performance criteria for December 1995 were fairly clear, but the achievement of the performance criteria for September would be heavily reliant on market developments in July and August--a period in which $6.8 billion of tesobonos would mature, thereby raising the possibility of renewed pressures on the peso and international reserves. Nevertheless, once the hurdles posed by the critical period of July-August were passed, the attainment of the September performance criteria would be in sight.

In view of the difficult period ahead, the staff and the authorities had agreed to include new performance criteria for the net international reserves and net domestic assets of the Bank of Mexico for end-July in the program, the Director said. The Mexican authorities considered that the inclusion of new performance criteria represented a strengthening of conditionality; for them, the performance criteria lag in the provision of data to the Fund would require a much shorter period than the usual 45-50 days. The required data would be made available to the Fund quickly, and the authorities agreed with the staff on the need for particularly close monitoring during July and August.

The staff paper on Mexico's request for a stand-by arrangement, which had been taken up for consideration by the Board in February 1995, had included a section on economic policies for 1996, the Director recalled. At that time, the staff and the authorities had indicated that the consideration of specific performance criteria for 1996 should be taken up at the time when the budget for 1996 was prepared. On that basis, performance criteria for 1996 were to be established at the time of the review of the stand-by arrangement scheduled for November 1995.

The staff's medium-term projections had been prepared taking into account likely developments in 1996, as well as over the repayment period, the Director noted. However, given the particularly grave situation in Mexico, the staff had been focusing its attention on developments over the shorter term. Specific targets for 1996 had not yet been set, but the Mexican authorities intended to pursue the policy path for 1996 described in their memorandum on economic policies presented to the Board in February 1995.

The staff was monitoring developments in the banking system closely, and data pertaining to the banks was being provided to the Fund fairly rapidly, the Director commented. On the basis of the information received thus far and discussions with the authorities, the staff considered that the problems of the development bank were similar to those of the commercial banks.

The loan restructuring scheme denominated in units indexed to consumer prices, Unidades de Inversión, could be seen as inflationary to the extent that any degree of indexation of an economy contributed to the inertial aspect of inflation, the Director considered. However, as the Unidad de Inversión was one of a few indexed instruments currently available in Mexico--and there was no indexation of wages--its contribution to the inertial element of inflation would be small. In that respect, it was to be noted that the monthly rate of inflation had declined from 8 percent in April, when the Unidad de Inversión was introduced, to 4.5 percent in May, and to 3.5 percent in June. On the basis of that trend, the Unidad de Inversión scheme could not be seen to have had an adverse effect on inflation rates.

As the penalty interest rate on past-due contracts was only 50 percent above the interest rate contained in original contracts, it was likely to remain below market interest rates reflected by Unidad de Inversión rates, the Director continued. While some debtors may not find the interest rate on the Unidad de Inversión to be an adequate incentive to clear their arrears, many that had long-standing relationships with their creditors would likely opt to participate in the scheme.

The behavior of the exchange rate had become significantly more stable since the establishment of the forward market, the Director noted. Although it would be difficult to establish a clear causal relationship between the establishment of the forward market and the behavior of the exchange rate, the forward market was clearly functioning well and it had helped to improve expectations in the market regarding future transactions.

The prevailing interest and exchange rates in Mexico were compatible, the Director of the Western Hemisphere Department considered. The sharp decline in interest rates was consistent with the tight monetary stance previously followed by the authorities and the actual decline in the rate of inflation, while the depreciation of the currency was likely to be slower, owing to market expectations concerning the underlying rate of inflation.

The Deputy Director of the Policy Development and Review Department stated that, while the recent imposition of trade restrictions by Mexico might be regrettable, those restrictions had not been imposed for balance of payments reasons. Therefore, the restrictions were not inconsistent with the program supported under the stand-by arrangement, and there was no need for the authorities to request a waiver of performance criteria related to them.

Although it would be highly unusual for the Fund to review the total access--of up to SDR 12,070.2 million--made available to Mexico under the stand-by arrangement approved in February 1995, the requirement of a balance of payments need would apply to all purchases under the arrangement, the Deputy Director noted. If the arrangement were to become precautionary, that would not preclude Mexico from making purchases in the future should a balance of payments need arise.

The summing up of the 1993 Article IV consultation with Hungary had included a reference to the Fund's expectation that Hungary would not make future purchases under its stand-by arrangement, the Deputy Director of the Policy Development Review Department recalled. Therefore, the case of Hungary could be taken as a precedent for the current discussion on Mexico.

Mr. Guzmán-Calafell said that the Mexican authorities remained committed to an open trade regime. The recent increase in tariffs for some industrial goods had been applied in accordance with World Trade Organization principles, and they were considered to be temporary, and conditional upon the restructuring of the industries affected. It should also be noted that the tariff increases applied to only 1.6 percent of merchandize imports.

Mr. Lanciotti made the following statement:

As I broadly agree with the staff appraisal, I would like to address directly the main problems related to the proposed decisions.

As I understand, the nonobservance of the performance criteria on net domestic assets and net international reserves for the first quarter is due to the smaller flow of financial support compared with the maturing tesobonos and the liquidity problems that have arisen in the banking sector. Most likely, the target will not be met in June, despite the expected improvement in reserves for the second quarter. However, the discrepancy in June will be much smaller than that registered in March.

In the light of these considerations, I support the authorities request for a waiver of the performance criteria on net domestic assets and net international reserves for end-March and for their nonapplicability for end-June.

As to the proposed decisions, in light of the positive economic developments in Mexico, we should reiterate the Fund's full financial commitment; this would help to maintain market confidence. An adequate financing sequencing is also necessary. The first tranche of the disbursement proposed by the staff, equivalent to $2 billion, should help substantially to cope with the large flow of maturing tesobonos expected for July-August.

Given the improvement registered in the stock of international reserves, the easier amortization of the public debt, and the intention of the Mexican authorities to forego purchases and make early repurchases as soon as international reserves permit, I would recommend consideration of the alternative draft decision suggested in the memorandum circulated by a number of Executive Directors, including myself, which would leave the determination of purchases in 1996 to future reviews.

Within a given amount of resources, I hardly understand why flexibility is useful with respect to the bilateral financing of the United States, as Ms. Lissakers argues, but harmful in the case of financing from the Fund--even keeping in mind the different purposes of the two kinds of finance.

Nevertheless, I would favor the proposal to include in the summing up of the current discussion an explicit statement that, prior to each purchase under the arrangement, the existence of a balance of payments need will be carefully considered and that purchases after August are presumed to be precautionary in nature. This is the explicit intention of the Mexican authorities. This would also avert any possible misunderstanding--although unlikely--that the Fund is not willing to maintain its full commitment to Mexico, which might hamper the sustainability of the country's economic program.

As to the concerns expressed by Mr. Berrizbeitia on whether this proposal might set a precedent, I would point out that such a precedent already exists.

Mr. Kannan made the following statement:

When the stand-by arrangement with Mexico was approved on February 1, 1995, the challenges faced by the Mexican authorities were so large and so numerous that many of us were somewhat skeptical as to whether the various performance criteria would, in fact, be met. This chair is happy to have been proven wrong in this respect. The turnaround in Mexico's economy in such a short period is remarkable. We congratulate the Mexican authorities and the people of Mexico on their extremely incredible achievement. There are no doubt slippages in a few areas. But these pale into insignificance when viewed against the backdrop of excellent performance in so many other areas.

In order to consolidate the gains, strong fiscal prudence and a tight monetary policy stance must be continued in the immediate period. As we are in agreement with the staff recommendations, I would only briefly mention a few important points: with reference to the exchange rate, we commend the authorities for their commitment toward maintaining the floating exchange rate regime, and this must be continued in the future; we encourage the authorities to expedite the privatization process, and in this respect we are happy to note the amendment of the Constitution; it should be the endeavor of the authorities to promote a viable banking system, and in this context vigilance will be necessary on the quality of bank's loan portfolios, if the volume of nonperforming loans is to be contained; we are happy to note that the authorities have taken important steps to expand the scope and improve the timeliness of economic data provided to the Fund.

With the restoration of confidence and policies firmly on track, we must allow some time for these policies to fructify and produce sustainable results. As the commitment of the authorities is clearly evident, we fully recommend the necessary waivers and endorse the decisions as proposed by the staff.

Ms. Srejber made the following statement:

Although confidence has recently started to return in the financial markets in Mexico, in response to the policy measures taken, especially in the fiscal policy area, it is too early to consider confidence well established, as the problems in the real economy will become all the more obvious after the immediate liquidity crisis has subsided and a substantial amount of tesobonos have matured in the next two months. As an abrupt reversal in financial markets' sentiment could lead to renewed financial turmoil, with negative effects for Mexico itself and for other countries in the region, I find it reasonable that we are asked to decide upon a small amount of front-loading of the remaining committed Fund resources. Today we have also been informed about the amount the other main contributor to the external financing package will disburse next week. However, at the same time, as I find a certain front-loading reasonable, I find it vital that the Mexican authorities are prepared to immediately take additional fiscal and monetary measures if this were needed to regain confidence. The burden put on financing, versus that on adjustment, has to be contained.

Like other Directors, I note that, although the fears of an imminent collapse of the banking system have abated, the situation in this sector is still fragile. The potential need to provide liquidity to the banks in distress constitutes a risk for the conduct of monetary policy, and the potential impact of the restructuring efforts on the budget will pose additional challenges for fiscal policy, although the costs may be spread over a number of years.

In light of the downside risks, both in terms of the possibility of a larger than projected fall in GDP and higher inflation, and the potential problems in the banking sector, it is crucial to maintain balance in the program in respect to the burden on fiscal and monetary policy. I share Mr. Kiekens's uneasiness about the lack of specification of the program for 1996, especially in view of the exceptional size of the financial support in this stand-by arrangement, which also makes an extraordinarily close monitoring and timely follow-up essential.

On trade policy, I note that there have not yet been any reversals in the imposed trade tariffs and measures against alleged dumping, and I urge the authorities to reverse these measures without delay.

On data provision, I welcome both the progress already made in the disclosure of data and the further improvements that are under way. The authorities must give the highest possible priority to this area. It is vital that all relevant data are produced, reported to the Fund, and published.

With regard to the proposed decision, I am prepared to grant the necessary waivers of end-June performance criteria, although it is regrettable that the monetary targets for June 1995 will not be met. I welcome the fact that the deviations have been reduced considerably, compared with those for end-March. I also welcome the commitment by the Mexican authorities to eliminate the deviations from the targets over the remainder of the year, and to further strengthen the policy stance if needed. Nevertheless, I would advise the Mexican authorities to pay increased attention to meeting the program criteria of net domestic assets and net international reserves and, if required, impose even more ambitious targets for the rest of the program period. The need to roll over a large share of the total debt stock has exerted almost continuous pressure on the financial markets. I note with satisfaction that Mexico has gradually regained access to international financial markets since mid-April. In these circumstances, I wonder whether any alternatives to the present debt management have been considered, in order to reduce the need for further exceptional external financing and deviations from the net international reserves target by actively lengthening the maturity of the outstanding debt.

On the proposed decision on the series of drawings, I would find it appropriate to consider alternatives along the lines described in the memorandum from some Executive Directors sent to the staff on June 28. I find these alternatives preferable to the suggested decision in the staff paper, both in view of the satisfactorily proceeding adjustment of the Mexican economy in recent months, and in view of the Mexican authorities' repeated assertions of their confidence that they will not need to draw on all the resources committed by the Fund.

I agree that it is desirable to give markets confidence that sufficient resources will be there to meet the financial obligations falling due during the summer months. However, I also consider that it would send a strong, confidence-increasing, and appropriate signal to the markets if, at the same time, the clear message were communicated that, in view of recent positive developments in response to the adjustment efforts, Mexico probably will not have to make further drawings after the first two tranches. This should, of course, be done within the context of reasserting the Fund's financial commitments to Mexico in accordance with the February 1 decision, and without hampering the conditionality. Like Mr. Kiekens, I think the assessments by Directors of the economic developments in Mexico are not so very different. Thus, I certainly hope that one of the two alternatives described in the memorandum will receive sufficiently broad support in the Board to ensure that the markets are left with no ambiguity as to the Fund's attitude at this stage about the possibility of continued positive development in Mexico. After listening to other Directors' views on the two alternatives, I think that it might be easier to reach agreement on something along the lines of the second alternative than on the first alternative.

However, irrespective of the form of our decision today, I urge the authorities to consider minimizing the actual total Fund credit outstanding as a priority objective. Indeed, I would find any early repurchases to be a strong confidence-enhancing signal. This would also be fully in line with the chief objectives of the program, namely, to restore confidence and reduce the dependence on foreign saving through a strong stabilization effort.

Finally, without intending to reopen the debate on the procedures followed in connection with the February 1 decision, I would like to emphasize that this extraordinary arrangement fully validates extraordinary efforts to keep our home authorities well informed about all the consequences of the arrangement. The accumulated drawing is the largest by a single country in the history of the Fund. I would like to mention that one piece of information that should not be forgotten is timely and transparent information on the distribution of this financing for the central banks involved, as the financing of the drawings may have a not negligible impact on the composition of creditor central banks' reserves.

Mr. Mozhin made the following statement:

There has been a remarkable improvement in Mexico. The lower peso has allowed to achieve a radical turnaround in trade and current account balances. At the same time, fiscal and monetary tightening has brought about declining inflation and falling interest rates. Meanwhile, the peso has appreciated somewhat, although the Bank of Mexico has been accumulating international reserves. External financing played a crucial role, as it allowed the authorities to service their dollar-denominated obligations.

There are more and more signs of revival in market confidence, such as the growing share of maturing tesobonos rolled over into peso-denominated instruments, the rising Mexican Brady bond prices, and the recovery of the Mexican stock market. Obviously, there are difficult times ahead, as it is expected that the output decline will intensify in the second and third quarters of this year, which will put additional strain on Mexico's fragile banking sector. However, the worst for the Mexican authorities may be over.

Back in February, when we discussed the Mexican program, we had plenty of reasons to hesitate, if only because of the unprecedented scale of Fund financing involved. With this in mind, I believe that now we should be grateful to the Mexican authorities, as their highly successful implementation of the program served well not only their own reputation, but also that of the Fund. One can only guess what sort of situation the Fund could have been facing had things developed in a less favorable way.

As I am in broad agreement with the staff's analysis, I will make only a few specific comments. There is very little emphasis in the staff report on the exchange rate policy. If this is due to the existence of a broad consensus among the Mexican authorities with respect to a continuation of the floating exchange rate regime, I would strongly welcome this fact.

With regard to the flavor of price controls in the public sector, and profit margin controls in the private sector, that was present in the original program, as there is no trace of this idea in the staff report, I understand that it did not materialize. Could the staff clarify this, and in particular, whether public sector prices were fully adjusted for inflation? The data in Table 46 of the background paper do not provide a clear answer.

Finally, with respect to the suggestion of the group of Executive Directors to modify the proposed decision, I would rather support the position of Mr. Berrizbeitia and Mr. Guzmán-Calafell. I do not think it is a good idea to create a precedent of backtracking on the Fund's commitments and penalizing a good performance. At the same time, I welcome the Mexican authorities' expectation that there will be no further purchases from the Fund after August 1995.

I support the proposed decision and wish the Mexican authorities every success.

The Chairman commented that the summing up of the current discussion would reflect the consensus reached among Directors.

Mr. Evans stated that the political and economic risks to the Mexican program were well known. Indeed, they had been exemplified in the authorities' inability to meet all of the performance criteria contained under the program for end-June 1995. Nevertheless, the authorities' determined pursuit of adjustment and stabilization policies clearly warranted continued support from the Fund.

Against that background, there were four main objectives for the current discussion, Mr. Evans considered. First, the Fund should send a clear message to the Mexican authorities and to the markets signaling its positive assessment of the progress made thus far. Second, the Fund should ensure that the conditionality associated with the stand-by arrangement for Mexico remained effective. Third, the Fund should convey a clear message that the full amount of access under the stand-by arrangement for Mexico would remain unchanged. Fourth, the Fund should signal its strong expectation that Mexico would not need to make drawings equivalent to the full amount of access available.

Although $6.8 billion of tesobonos were to mature in July-August 1995, the current account position was nearly in balance, and the Mexicans had recently succeeded in rolling over about one half of the tesobonos, Mr. Evans said. Based on those considerations, if the United States' disbursements paralleled the Fund's disbursement of $3.5 billion in July-August 1995, Mexico would clearly be a in position to redeem the tesobonos, and the drawings from the Fund could be used to build up reserves.

However, it was important to note that there could be several reasons for the sharp decline in the rate of rollover of tesobonos in recent weeks, Mr. Evans continued. First, the markets could be uncertain about the availability of adequate finance from the Fund and the United States. Second, there could be market uncertainties about the sustainability of the Fund-supported program, in particular with respect to addressing the fragility of the banking system. Third, current interest rates, which had recently been reduced to about 40 percent, could be seen by the markets as providing insufficient incentives.

At least two of the above-mentioned concerns could be alleviated by the outcome of the current discussion, Mr. Evans went on. Indeed, making public the Fund's positive assessment of the situation in Mexico would go a long way toward alleviating any doubts about the sustainability of the program supported by the stand-by arrangement. Nevertheless, he wondered whether the recent decline in the level of interest rates had eroded the incentive for investors to participate in the rollover of tesobonos.

In considering the availability of financing from the Fund and the United States, the purchases under the stand-by arrangement for July and August 1995 could be taken together, as the purchase scheduled for August involved little additional conditionality, Mr. Evans added. In that respect, he had no difficulty supporting additional financing from the Fund of $3.7 billion. However, it was disappointing to note that the United States was prepared to commit only $2.5 billion in July. While he could understand the U.S. authorities' desire to retain flexibility with respect to disbursements of aid, it would be consistent with their previous statements to parallel the level of finance made available by the Fund.

He welcomed the reassurance provided by the Chairman that the summing up of the current discussion would fully reflect the views expressed by Directors, Mr. Evans stated. In that connection, it would be important to reiterate that Mexico would need to demonstrate a balance of payments need to make purchases beyond August 1995 and the expectation expressed by several Directors that such purchases probably would not be necessary.

Ms. Lissakers noted that if the United States had made disbursements of aid to Mexico in parallel with the Fund, it would have disbursed only $7.8 billion, as opposed to $10 billion, thus far.

Mr. Evans asked whether the United States intended to reduce its disbursements of aid to Mexico to match the assistance provided by the Fund over time.

Ms. Lissakers replied that the U.S. authorities had never indicated that disbursements of financial assistance from the United States should parallel drawings on the Fund. The U.S. commitment was to make financial assistance of up to $20 billion available to Mexico as, and when, it was needed.

Mr. Link made the following statement:

We are encouraged by the positive developments on the financial and exchange markets since the significant tightening of the fiscal and monetary policies in early March. The appreciation of the peso from its low level at end-February, falling interest rates, and a marked recovery of the stock market indicate a turn for the better. However, the short time span since the introduction of additional measures makes it difficult to interpret these improvements. It would appear hasty to conclude--based on the past two months--that a general improvement in confidence has taken place in Mexico.

Therefore, we agree with the cautious stance of the staff in assessing the recent developments. We share the view that substantial risks are present and that the economic situation remains fragile. We would like to underscore the following concerns for emphasis.

Although the banking system has so far withstood the financial crisis, it is still difficult to assess the magnitude of the repercussions of the crisis in the banking sector. Still-high interest rates and the stronger than expected contraction of the real sector will surely exacerbate problems with nonperforming loans, thereby increasing the reliance of banks on the various support schemes put in place by the authorities. This will further increase the already substantial costs associated with these schemes and increase the fiscal burden in the medium term. In the short term, the further deterioration of the situation of the banking system could also seriously endanger the envisaged monetary policy goals.

We are concerned about the nonobservance of the performance criteria for net international reserves and net domestic assets. Although substantial deviations from the program figures for both criteria were registered in March, the staff report merely notes that in June a large reduction in the deviation, compared with that for end-March, is likely. We wonder whether the original program is still realistic, given that a deviation for two criteria has been accepted for the second time. Our understanding is that a performance criterion in a program normally must be achieved to complete a review. Accepting waivers too easily undermines the credibility of the Fund programs. We would have appreciated a more detailed explanation of the current deviations.

As regards monetary policy, we agree with the staff that past developments in base money have created a danger of an undue increase in monetary growth within the parameters of the program. In the light of the higher than programmed net domestic assets, financial and inflation indicators will have to be monitored closely, and the Mexican authorities are expected to take the appropriate monetary and fiscal actions in a timely manner, should tensions appear.

We would also be interested to learn the results of the authorities' considerations with respect to the creation of a trust fund within the Bank of Mexico, which would be used to amortize tesobonos and the short-term external liabilities of commercial banks. This instrument, which was mentioned in the previous staff report, should have improved the transparency of monetary policy.

As regards fiscal policy, the authorities could face considerable pressure to further reduce noninterest expenditures in view of the high probability that the decline in real GDP will be greater than projected, and inflation higher. In this context it is interesting to note that private sector forecasters are currently projecting a 3-5 percent decline in real GDP, and the World Bank projected a 4.5 percent decline in its recent report. Should this more pessimistic scenario become reality, we would expect the authorities to be ready to compensate for lower revenues.

At the same time, it still remains necessary to fully implement the social safety net measures, as planned. The further deterioration of the economic situation will have an important impact on the poorest population groups, and an outbreak of social tensions could seriously endanger the ongoing adjustment process.

Developments in the external sector have been very encouraging. In this context it is unfortunate that the authorities felt it necessary to increase import tariffs on certain products. We urge the authorities to reverse at the earliest these decisions, which harm their liberalization record.

As regards the proposed decisions, in view of the substantial risks associated with Mexico's adjustment efforts, it is crucial that the positive developments of the past months be backed by sufficient international support, especially in view of the forthcoming test of market confidence in July and August, when large amounts of tesobonos will mature. We also note that, in view of the improved balance of payments position and the relatively small tesobono amortizations scheduled after August 1995, the external financing needs in the last quarter will be substantially smaller. Against this background, we welcome the Mexican authorities' intentions to limit, as much as possible, their exposure to the Fund.

Although this chair would have preferred a draft decision that reflected this intention in some formal way, we could go along with the proposed draft decisions attached to the staff report. At the same time, we are satisfied with the note, dated June 29, 1995, from Mr. Berrizbeitia and Mr. Guzmán-Calafell to Executive Directors, which provides welcome clarifications of their authorities' understanding of the essentially precautionary nature of the program, should the positive developments persist and financial market confidence continue to increase as expected. We trust that the Mexican authorities will carefully assess, in cooperation with the staff, their balance of payments needs prior to making any further purchases after August 1995. We would also request that this note be made part of the records of this meeting, and that it be reflected in the summing up.

After adjourning at 12:45 p.m., the meeting reconvened at 2:05 p.m.

The Director of the Western Hemisphere Department said that the lengthening of maturities had facilitated the improvement of debt management in Mexico. The maturities on treasury bills had been extended from 28 days with reissuance of 182-day treasury bills in May 1995. Tesobonos were no longer being issued, and they were being replaced by longer-term instruments denominated in local currency. Nevertheless, the surplus of the public sector was perhaps the most important contributor to effective debt management in Mexico.

Although the authorities had considered establishing a trust fund for the management of tesobonos at one time, upon more careful analysis of the situation, they had determined that the creation of a formal instrument would not be necessary, the Director stated. Indeed, experience showed that the mechanisms for the rollover of tesobonos into peso-denominated securities were working well.

The Bank of Mexico and the Government agreed that the floating exchange rate policy had served Mexico well thus far, the Director said. At the current stage, the authorities did not have any plans to modify the exchange rate system.

The dominant factor behind the decline in interest rates in Mexico was the reduction in inflationary expectations, the Director considered. The fiscal surplus was also contributing to the decline in interest rates to the extent that it had reduced the overall stock of debt in the market. The securitized debt of the Government had declined substantially since the end of 1994, partly owing to the repayment of tesobonos, and because of the surplus of the public sector.

The authorities intended to maintain a very tight monetary policy stance over the period ahead, the Director of the Western Hemisphere Department noted. The depreciation of the exchange rate over recent weeks was attributable primarily to market uncertainties about the availability of financing to Mexico. At the present stage, the exchange rate seemed to be dominated more by market forces than by monetary policy.

Mr. Mirakhor said that he could associate himself with the comments put forward by Mrs. Cheong for the current discussion.

Mr. Fukuyama made the following statement:

> I support the decisions proposed by the staff. It is encouraging that the market conditions have improved since March. However, as maturing tesobonos will be concentrated in the period between July and August, it is important to send a strong signal to the market, so as not to undermine the recovery of market confidence. To this end, the authorities should make clear their firm stance to maintain prudent and tight fiscal and monetary policies. The Fund should also make clear that it fully supports the authorities' efforts. In this connection, the proposed decisions, including the front-loading of the additional financing, will play a large role in maintaining the momentum of economic recovery in Mexico. The first alternative suggested by eight Executive Directors has the risk of undermining the market confidence. I do not think that these Directors have convinced us that this will not be the case.
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> It is my understanding from the staff paper that the Mexican authorities do not intend to make further purchases unless absolutely necessary, and intend to make early repurchases as soon as conditions permit. If the Mexican chair reaffirms the

authorities' intentions as to these points, I do not think it is necessary to adopt the second alternative suggested by the eight Directors. It is enough to record in the summing up that the Directors noted the authorities' intentions and hoped that economic conditions in Mexico would permit such intentions to be realized. In this respect, I believe that there is good reason for the Mexican authorities to refrain from unnecessary purchases, as the no-more-purchase declaration, after overcoming the difficult period between July and August, will be a victory for the Mexican authorities.

As I do not have much to add to the staff's appraisal on individual policies, I will just comment briefly on one or two areas. As the staff paper notes, the success of the program will depend heavily on two elements: progress in the restructuring of the banking system, which is suffering from bad loans, and assurance of the necessary financing to amortize the maturing tesobonos. Approval of the proposed decisions would lead to an improvement in market confidence, thereby easing the risk related to the amortization of the maturing tesobonos. However, on the restructuring of the banking system, the effect on the fiscal situation of the loan restructuring scheme that was introduced in April to address the banking system problem is very uncertain. As to policies, I would just mention that, if there is a large budgetary expenditure under this scheme, it could have adverse effects on market sentiment. It is important therefore to monitor expenditures related to the banking restructuring and to try to avoid any loss of confidence by taking additional expenditure restraint measures, if necessary.

Finally, I hope that the authorities will keep in close contact with the Fund staff.

Mr. Al-Tuwaijri made the following statement:

Developments in Mexico over the past few months have been most encouraging. Following the welcome strengthening of Mexico's economic program in March, the peso appreciated, interest rates declined, and the stock market rose sharply. This positive reaction in the financial markets should encourage the authorities to further reinforce their adjustment efforts. As I am in broad agreement with the thrust of the staff report, I will make only a few brief comments.

First, the authorities are commended for the progress made in strengthening the fiscal accounts. The much better fiscal outturn in the first quarter and indications that the June target will be met with a comfortable margin are reassuring. However, this is no time for complacency. Continued overperformance on the fiscal front is necessary to reduce the burden on monetary policy. This is especially important at this juncture, as the need to contain inflation remains paramount, while interest rate increases will likely further undermine an already fragile banking sector.

Second, addressing the difficulties faced by the banking sector is one of the major challenges facing the authorities at this time. In his statement, Mr. Guzmán-Calafell detailed a number of measures that have been implemented in order to alleviate these difficulties. The increased emphasis on bank supervision and the approval of legal amendments to improve capitalization of the financial sector are most welcome. However, I am somewhat skeptical with regard to other schemes to increase bank capital and restructure nonperforming loans. While the staff analysis indicates that the cost of these schemes is lower than the cost of doing nothing, the analysis does not indicate whether these schemes are the most efficient way to handle the situation. Moreover, it is important not to underestimate the moral hazard created by such schemes.

Third, maintaining at least balance in the overall external accounts is needed, to avoid putting pressure on the exchange rate. Thus, a major improvement in the current account deficit in 1995 is crucial in view of the expected decline in capital inflows. In this connection, current account data for the first few months of the year are encouraging. It is important, however, to achieve such improvement without resorting to trade restrictions.

Finally, while appropriate policy measures are paramount for regaining financial market confidence, the availability of adequate financing remains critical. This is particularly relevant at this time, in view of the bunching of maturing tesobonos over the next two months. Thus, I am encouraged by Ms. Lissakers's announcement this morning that the United States expects to provide Mexico with US$2.5 billion next week. This disbursement, along with completion of this review, will send a most reassuring signal. In this regard, I found the proposed phasing of purchases from the Fund appropriate, and I support the staff's proposed decision. I also welcome the assertion in Mr. Guzmán-Calafell's statement that the Mexican authorities do not expect to make further purchases after August of this year. However, it is hoped that the situation will improve sufficiently for Mexico to make early repurchases from the Fund.

Mr. Dlamini made the following statement:

It took an additional dose of corrective action in March for Mexico to get the attention of the markets. The lesson is that regaining market confidence is an uphill battle, requiring strong policies that send a clear signal of commitment to reform. Thus, we encourage the authorities to be prepared to take timely action to strengthen the adjustment effort should that be necessary. Meanwhile, the Fund must continue its financial support for Mexico, as it is one of the main pillars on which the program is built. A major part of the confidence rebuilding exercise now under way in Mexico is the assurance of sufficient financing to cover its external obligations as they fall due. Therefore, I can support the staff's proposal.

There are a number of developments that augur well for the future. The country's diversified export base is responding well to improved competitiveness; private capital outflow has slowed markedly; and headway is being made on the inflation front. Moreover, steps are being taken to speed up the process of privatization and deregulation. Nevertheless, the rapid progress toward stabilizing the country's financial situation has come at the expense of a decline in economic activity and a sharp increase in unemployment. These conditions cannot persist for too long without straining support for the reform effort. It is important in this connection that steps be taken to increase investment, including finding ways to attract more foreign investment. There is also the problem of the continuing deterioration of bank's loan portfolios. Against this background, I welcome the technical assistance that is being provided by the World Bank and the IDB to help the authorities in the restructuring exercise. It goes without saying that the soundness of the banking system is critical to improving confidence in the economy.

In sum, I think that the policies of the authorities are in the right direction, and there is a good chance that the economy will emerge stronger and more competitive than before the crisis.

I support the staff proposal and wish the Mexican authorities success.

Mr. Wijnholds made the following statement:

The strong commitment of the Mexican authorities to pursue sound monetary, fiscal and structural policies and the disbursements from the international financing package have contributed to a strong improvement of the current account and an encouraging but as yet modest recovery of financial markets' confidence in the Mexican economy.

I would like to make some remarks on the projections made in the report and the uncertainties that surround them. First, attempts to protect the banking system have already been and will continue to be implemented. However, the deeper than expected recession will probably bring about a growing number of non-performing loans; this might well have an adverse impact on economic recovery. Economic growth forecasts (1995: - 2 percent; 1996: + 2 percent) therefore need to be viewed with great caution. I note, for instance, that the OECD recently projected a larger contraction of real GNP for this year than the Fund staff.

Second, as mentioned in the staff appraisal, the fiscal costs of the restructuring of the banking system could lead to an additional burden for fiscal policy over the next few years. Could the staff give an indication of the potential burden?

Let me conclude that, on balance, economic developments in Mexico are truly encouraging. I also wish to express appreciation for the strong commitment to adjustment of the Mexican authorities and the recent improvement in the provision of statistics. I furthermore welcome the belated opening of a Fund resident representative office in Mexico, and hope that the authorities will make good use of Mr. van Houten's presence in their country. Like some other Directors, I wish to explicitly express my disappointment at the introduction by Mexico of trade restrictions. The fact that they were not taken for balance of payments reasons may preclude the necessity for a waiver. The fact remains that this is a measure generally considered to be harmful for both its trading partners and the country itself.

I can agree to the proposal of granting waivers for non-observance of two performance criteria. I also agree to re-asserting the full extent of the Fund's financial commitments to Mexico, and to the degree of front-loading proposed. At the same time, I believe that, after the hump in the amortization of Tesobonos in July and August, Mexico would not need further purchases, and could even be in a position to make early repurchases. Therefore, together with a number of other Directors, I would strongly favor to include in the summing up a statement that the balance of payments need be carefully considered prior to each following purchase, and that we expect the arrangement to be of a precautionary nature after the August purchase.

Ms. Srejber asked whether the purpose of a summing up was to reflect the consensus reached among Directors or to reflect the discussion itself.

The Chairman said that every effort would be made to ensure that the summing up would reflect the sense of the current discussion.

From the views expressed by Directors for the current discussion, he considered that it would be important for the summing up to reflect the expectation that, given a sustained application of policies, the stand-by arrangement for Mexico could become precautionary beyond August 1995, the Chairman stated.

Mr. Ismael made the following statement:

At this point, I would like to associate myself with the statements of Mr. Kafka and Mr. Shaalan, as I broadly agree with the issues that they have raised.

I would also like to commend the Mexican authorities for the strong determination shown in implementing the envisaged measures, which have allowed for a remarkable improvement in the financial situation of the country. However, like others, I note that risks and uncertainties remain, especially in the banking system. This would indicate that the authorities will have to remain vigilant and be prepared to take additional measures, if the need should arise. Continued assistance from the international financial community will still be required to support the authorities' efforts.

I also share the views expressed by some speakers regarding the need to pay greater attention to the growing social problems associated with the crisis, and I hope that an appropriate safety net will be put in place.

In addition, I broadly share the thrust of the staff's appraisal. I support the request for waivers and the proposed decision.

Mr. Petrie made the following statement:

Like others, we very much welcome the remarkable improvement in the overall economic performance of Mexico, for which the Mexican authorities need to be congratulated. The additional policy measures they took earlier this year have clearly been a central factor in this turnaround.

We accept that market confidence remains fragile, however, and that Mexico's recovery could be damaged if the current review were not completed. We are therefore prepared to support granting the necessary waivers for the second review to be completed, although we are concerned about the nonobservance of two of the key targets.

On the proposals of the group of eight Directors, it appears their first alternative will not gain sufficient support in the Board. I support their alternative suggestion that language be included in the summing up along the lines they propose.

In supporting this proposal, I would agree with the statements made by Mr. Autheman, Mr. Schoenberg, and others concerning the neutral, or possibly positive, impact this would be likely to have on market confidence, if presented carefully; and the lack of force in appeals to Fund precedent and history, in the context of the unprecedented Mexican rescue package.

Finally, I would like to wish the Mexican authorities continued success in their efforts.

Mr. Guzmán-Calafell thanked Executive Directors for their constructive comments and their strong support for Mexico's economic adjustment program. His authorities saw the alternative proposals put forward for the current discussion as a well-intentioned effort to strengthen market confidence in Mexico's economic program, while protecting the Fund's interests. Nevertheless, given the precarious nature of market sentiments, they would prefer to take a cautious approach.

The Mexican authorities had designed a social safety net to alleviate the impact of high inflation rates and economic recession on the poorest segments of society, Mr. Guzmán-Calafell said. Social outlays currently accounted for over 50 percent of programmed public expenditures. In that respect, it should be noted that the rapid increase in social expenditure since the late 1980s had already achieved substantial improvements in the social infrastructure. In addition, the impressive moderation of wage demands and the expansion of the informal market had helped provide a cushion against increasing unemployment. Nevertheless, the economic difficulties currently faced by Mexico would inevitably entail high social costs.

In the circumstances, his authorities considered that any weakening of the adjustment effort would only increase the social impact of the crisis, Mr. Guzmán-Calafell stated. Therefore, they remained committed to pushing ahead with strong policies aimed at overcoming the economic problems quickly in order to contain the overall social costs to the shortest possible time frame.

As indicated in the National Development Plan for 1995-2000, the central objective of economic policy over the longer term was to foster strong and sustainable growth rates, Mr. Guzmán-Calafell commented. In order to satisfy the demand for employment in Mexico, an annual growth rate of about 5 percent would need to be achieved. As that objective could not be met in the absence of a substantial increase in the domestic savings rate, several challenges needed to be overcome to promote domestic savings. On the one hand, it would be critical for Mexico to successfully overcome the current crisis; it would be impossible to increase the savings rate in an unstable macroeconomic environment. It would also be important to consolidate and intensify the structural transformation of the economy that began in the 1980s, and to set in motion a number of reforms aimed at achieving a wide and stable basis for increased domestic saving. The latter objective would need to include fiscal reforms, further adjustments to the financial system, and a deep-seated transformation of the social security system.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal for the 1995 Article IV consultation with Mexico. They were most encouraged by the fact that, following the tightening of monetary and fiscal policies in early March, Mexico's economic performance had improved markedly: the public finances had been stronger than programmed; the external trade balance had shifted into a sizable surplus; and improved financial market sentiment had led to greater stability of the peso and a rebound in domestic financial markets. Moreover, the rate of inflation had begun to decline, while the sharp fall in output should begin to level off later in the year.

Directors were impressed by the courage and determination of the authorities, and considered that Mexico's current policy stance was appropriate, while emphasizing the need to maintain a tight monetary policy to help further reduce the rate of inflation and stabilize financial markets. They shared the staff's assessment that, with continued strong macroeconomic policies and adequate support from the international community, the program's main objectives would be achieved. Moreover, continued sound economic policies and structural reforms should keep the external current account at a sustainable level, while promoting a recovery in economic activity. Although the program's performance criteria for net international reserves and net domestic assets of the Bank of Mexico for end-June would not be met, it was observed that the deviations with respect to the program targets were significantly lower than for end-March, and Directors supported the necessary waivers.

Directors underscored the potential for reversal in market sentiment in July-August, when large amortizations of tesobonos would fall due, if there were uncertainties about continued international support for Mexico's efforts. They welcomed the decision by the United States to disburse $2.5 billion in July, and the reiteration that additional funds would be available as may be needed in August to help in amortizing tesobonos. In this context, Directors saw the close monitoring of the program as very important to give the authorities the opportunity to make policy adjustments as required.

Directors emphasized that the assurance of sufficient international funding would strengthen market confidence and contribute to further accumulation of international reserves in the remainder of the year. In this context, all agreed that the next two purchases--through August--were required as a signal to markets of the continued official support for Mexico's program, and they were needed to support the reconstitution of external reserves. Many Directors cautioned, however, that the issue of need thereafter should be carefully considered by the authorities prior to making further purchases under the arrangement.

Directors generally believed that with the continuation of appropriately tight policies, confidence should be sustained and normal access to international capital markets could be restored. In this context, Executive Directors considered that if the balance of payments and international reserves improved as projected under the program, the authorities would be able to treat the arrangement as precautionary beyond August. Accordingly, Directors welcomed the reiteration by the authorities of their intention to forego some purchases from the Fund if the economic situation stabilizes and to make early repurchases from the Fund if reserves permit.

Directors observed that the main monetary policy risks over the balance of the year would appear to come from possible financial market pressures, if there were inadequate external financing, and from problem banks. To avoid these risks undermining the success of the program, the authorities will need to closely monitor financial and inflation indicators and be prepared to take additional fiscal actions if needed.

Directors observed that the further deterioration in commercial banks' loan portfolios constituted a potential risk for the solvency of the banking system and the success of Mexico's adjustment program. While recognizing the important programs that have been put into effect, Directors emphasized that the restoration of the health of the banking system will depend mainly on the restoration of macroeconomic stability and on a financial restructuring of the weaker banks. Some fiscal support was likely to be needed over the next few years. Consequently, Directors underscored the need for further consolidation of the public finances, including through a comprehensive reform of Mexico's tax system. In this connection, Directors welcomed the Government's request for technical assistance from the Fund's Fiscal Affairs Department.

Directors expressed concern about the recent imposition by Mexico of import tariffs on textiles and footwear, and urged the early removal of these tariffs.

Directors commended Mexico on the recent improvement in the scope and quality of statistical information being made available to the Fund and for publication. They hoped that progress in this area would continue.

It is expected that the next Article IV consultation with Mexico will be held on the standard 12-month cycle, and that the next review under the stand-by arrangement will be completed by mid-November 1995.

The Executive Board took the following decision:

1. Mexico has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for Mexico (EBS/95/15, Sup. 3), in order to review Mexico's performance under the program supported by the stand-by arrangement.

2. The letter dated June 20, 1995, with its annexed technical memorandum of understanding, from the Secretary of Finance and Public Credit and the Governor of the Bank of Mexico shall be attached to the stand-by arrangement for Mexico, and the letter dated January 26, 1995, from the Secretary of Finance and Public Credit and the Governor of the Bank of Mexico, with its annexed memorandum of economic and financial policies and technical memorandum of understanding, shall be read as supplemented by the letter dated June 20, 1995 and its annexed technical memorandum of understanding.

3. Accordingly,

Paragraph 1 of the stand-by arrangement shall read as follows:

"1. For the period from February 1, 1995 to August 15, 1996 Mexico will have the right to make purchases from the Fund in an amount equivalent to SDR 12,070.20 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund."

Paragraph 2 of the stand-by arrangement shall read as follows:

"2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 6,549.9 million until August 15, 1995, the equivalent of SDR 7,653.96 million until November 15, 1995, the equivalent of SDR 8,758.02 million until February 15, 1996, the equivalent of SDR 9,862.08 million until May 15, 1996 and SDR 10,966.14 million until August 10, 1996.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Mexico's currency subject to repurchase beyond 25 percent of quota."

Paragraph 3(b) of the stand-by arrangement shall be replaced by the following:

"(b) during any period in which the data at end-July 1995 indicate that

(i) the target for the net international reserve of the Bank of Mexico described in paragraph 1 of the technical memorandum of understanding annexed to the letter dated June 20, 1995, as adjusted in accordance with paragraphs 11 through 14 of the technical memorandum of understanding annexed to the letter dated January 26, 1995, or

(ii) the ceiling on the stock of net domestic assets of the Bank of Mexico described in paragraph 3 of the technical memorandum of understanding annexed to the letter dated June 20, 1995, as adjusted in accordance with paragraphs 11 through 14 of the technical memorandum of understanding annexed to the letter dated January 26, 1995 is not observed, or"

Paragraph 3(c) of the stand-by arrangement shall read as follows:

"(c) After June 29, 1995, November 14, 1995 and May 14, 1996, until the respective reviews contemplated in paragraph 1 of the attached letter are completed, or".

4. The Fund decides that the first review contemplated in paragraph 3(c) of the stand-by arrangement for Mexico is completed and that notwithstanding the nonobservance of the performance criteria specified in paragraphs 3(a)(v) and 3(a)(vi) of the stand-by arrangement, and the nonavailability of data with respect to the performance criteria specified in paragraphs 3(a)(i) through 3(a)(iv)

of the stand-by arrangement, Mexico may proceed to make purchases for up to the equivalent of SDR 6,549.9 million until August 15, 1995.

Decision No. 11024-(95/64), adopted
June 30, 1995

3. IRELAND - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Ireland (SM/95/143, 6/9/95; and Sup. 1, 6/28/95). They also had before them a background paper and statistical appendix (SM/95/146, 6/21/95).

Mr. Murphy made the following statement:

The Irish economy is going through a robust growth phase at present, having escaped relatively unscathed from the latest world downturn. Employment has been growing strongly, but unemployment remains the principal concern in the economic conjuncture, with few prospects that employment growth will reduce it rapidly. The fiscal outturn of recent years has been good on a net basis, with public debt falling quickly and official targets outperformed for the past couple of years. However, public expenditure has burgeoned and its control is now a central policy issue. Structural reform continues apace, and much remains to be accomplished in this domain.

With regard to economic developments and outlook, short-term indicators for the Irish economy are little changed since the staff visit for the Article IV consultations. Thus, GNP growth is expected to be above 5 percent this year, as high as 5.75 percent according to the Central Bank; both external and domestic demand are contributing strongly; a large external surplus is expected; inflation is stable at 2.5 percent; and unemployment is falling slowly, but is still near 14 percent.

Medium-term prospects for the economy, as finalized recently by the Department of Finance, envisage growth of the economy in 1996 similar to that for 1995, with a rate of over 3.5 percent prevailing thereafter to 1999. The Central Bank would see potential for considerably higher growth in the medium term. Inflation moves up somewhat later in the medium-term scenario, by about 0.25 of a percentage point; the balance of payments surplus remains high at about 6 percent; employment grows at about 1.5 percent a year. The assumptions underlying this stylized outturn include OECD forecasts for the world economy as modified by European Commission forecasts, unchanged domestic fiscal policies, and base postbudget official forecasts for the economy for 1995. I will return to the subject of the medium term later, to examine the variation in the fiscal stance in achieving the policy aims.

The aim of monetary and exchange rate policy is price stability. In view of the extremely open nature of the Irish economy--exports plus imports are equivalent to about 100 percent of GDP--inflation control has been pursued through exchange rate stability in the exchange rate mechanism (ERM) of the European Monetary System (EMS), supported by foreign exchange market interventions and monetary policy formulated by the Central Bank.

The pursuit of exchange rate stability within the ERM has been complicated from time to time in recent years, and most recently around the time the staff mission was in Dublin, by the effect of sharp short-term divergences between sterling and ERM exchange rates. Rapid and large depreciations in sterling have been reflected in markdowns of the Irish pound in terms of ERM currencies in the very short term. Over time, markets seem able to accommodate Irish pound appreciation vis-à-vis sterling more readily, and such appreciation has characterized recent experience.

The cause of market linkage of the Irish pound and sterling in the short term is to be found in traditional market ties between the Irish and U.K. economies. About 20 percent of Irish exports are both to the United Kingdom and sterling denominated. Although this proportion has become low--it was over 50 percent some years ago--it has a particular significance arising from the fact that the labor content of exports to the United Kingdom is very high relative to that of exports to ERM country destinations. Hence, there has been a mistaken perception by some that appreciation in terms of sterling would not be tolerated by the authorities. To some extent this is being overcome, as the resolution of the most recent episode shows, but I would not rule out difficulties arising from any future abrupt divergences between sterling and ERM currencies, or market anticipation thereof.

Let me return to the current experience and the stance of policy. Clearly there is some tension between the staff and my authorities on the appropriate stance of monetary policy to support exchange rate policy. If my authorities thought tighter monetary policy was warranted earlier in 1995, they would have made it so, but they did not. Looking forward, my authorities would not rule out following a tighter course in pursuit of their aims, which do include early membership in the economic and monetary union. However, let me put down markers that might help you to interpret their intentions.

First, the Irish pound is trading comfortably alongside other ERM currencies of the former narrow band, and the effective exchange rate index is stable to appreciating, with no problem for overall competitiveness--conditions that are regarded as quite acceptable by my authorities. There is no more exact target, in terms of other ERM currencies, for which they are aiming on any given day. However they might prefer and support, in appropriate circumstances, a higher position in the current ERM band.

Second, despite the fact that criteria for measuring full capacity utilization are tight as can be, my authorities look upon these measures as not very significant in the context of so open an economy with a considerable reserve labor force. The growth of private sector credit, which is running somewhat ahead of its forecast, is not regarded as unusual in light of its investment content to date, the customary pace at this stage of the cycle, and the fact that major banks report a slowdown in demand. There is no pressure on incomes. Some evidence of an impending surge of inflation would be troubling, but none is in evidence.

In conclusion, tighter monetary policy is not ruled out, but my authorities are not giving any signal of an intention to move the exchange rate up in the ERM band through the exercise of discrete market pressures.

The details of fiscal policy in 1995 are set out clearly in the staff report, as are the parameters for the subsequent two years set by the Government, which came into office this year. The general government deficit/GDP ratio will be kept within 3 percent, public debt will stay on a downward course, and current discretionary public expenditure will be limited to 6 percent nominal growth this year--6.9 now that a court decision on certain disbursements has been delivered--with the extra 0.9 being deducted from the base for later limit calculations and 2 percent a year real increases in 1996 and 1997.

Fiscal policy in the past few years has had outcomes well ahead of expectations in terms of public debt reduction, with falls of near 5 percentage points a year in 1994, which are again anticipated this year. This has been achieved in the context of high growth and buoyant revenue, with deficits well within targets. Government expenditure and revenue are both reducing in proportion to GDP. Nevertheless, fiscal policy has become procyclical, and the net outcomes mask an evolution of expenditure that is not sustainable, as the staff points out, as my authorities recognize, and as Executive Directors already remarked last year.

In light of this, on assuming office the new Government included in its program the 2 percent real expenditure limits, referred to above, for the next two years. Even these limits, however, are now viewed with some unease, and two strands of strengthened policy are being pursued.

The preparation of estimates for the 1996 budget has been launched already, and in a very public way, and the overall limits needed to secure a result within the 2 percent parameter have been set up for government departments prior to their submissions, in a streamlined timetable for compliance and government decision making.

Reduction of the public sector pay bill by freezing recruitment in the public service is in process. Taken together with expenditure cuts, this should help push restricted current expenditure well below the 2 percent limit, possibly halving it.

In the medium-term economic scenario that I sketched above, the fiscal outcome would result in a general government debt/GDP ratio declining by about 3 percentage points per annum to the end of the millennium. The additional expenditure reduction arising from the planned public sector shrinkage will reinforce this trend, and is being set in a context stretching several years ahead. However, I do not have a reworking of the medium-term arithmetic to make public debt effects more precise.

I should add that it is not true to say that all contingencies are outside of the budgetary planning process. Contingencies with relatively high probabilities attaching to them are already in the estimates procedure for next year and will be included in subsequent years, so bringing them within expenditure growth limits. Contingencies so included already embrace pension fund consolidation in some state enterprises and capital contingency provisions for financial restructuring in the public sector.

For some years now, successive budgets have been used to address structural issues affecting the labor market. The thrust of policy is to remove impediments to participation in the labor market arising from the tax code; the staff report provides details of the budgetary efforts in terms of the tax wedge. At the same time, considerable attention has been focussed on training to facilitate participation in employment. Employment is now growing fairly strongly, and services have had a large share of growth. However, my authorities do not view this fact as a sign of a job completed. On the one hand, the adjustment of the tax system is still regarded as work in progress, with much remaining to be done. On the other hand, much of the training efforts of public authorities have come in for critical comment and review.

As regards the state enterprises, considerable progress has been made in recent years in their restructuring to eliminate dependence on government, recognizing the competitive environment in which they must operate. Hence the Government has set up commercial benchmarks for performance. The current government does not envisage significant privatization at present.

Openness to competition and participation by foreign financial institutions have been characteristics of the Irish financial system since the 1960s. A substantial body of prudential banking supervision legislation has been on the statute books for a quarter of a century. It was updated substantially in a succession of acts over the past seven years, to deal with evolving best international practice and to include investment services, stockbrokers, moneybrokers, certain securities houses, futures, and options exchanges, and collective investment undertakings--mutual funds. Much of this legislation is based on or is ahead of European Union (EU) legislation on which it is being aligned as new laws are enacted and implemented in the Union as a whole.

Extending his comments, Mr. Murphy noted that the updated information provided by the staff could give a misleading signal that there were differences between the staff and the authorities on the likely direction of changes in the exchange rate. At the present stage, the authorities and the staff would probably agree that the exchange rate was likely to remain stable over the period ahead.

Ms. Srejber made the following statement:

The steadfast pursuit of a disciplined and outward-oriented economic strategy for several years has given Ireland a rather balanced macroeconomic position and rapid economic growth. Ireland's decisive adoption of a front-loaded fiscal consolidation program relying on expenditure reductions launched this policy in the late 1980s. The good Irish economic performance makes Ireland an interesting case for comparison for many countries with excessive budget deficits.

In addition to rapid economic growth, Ireland has been among the best performers in the EU, with respect to the fulfillment of the Maastricht criteria, and Ireland's objective of early entry into the third stage of the economic and monetary union seems very realistic if the disciplined policy is continued.

As we are in broad agreement with the thrust of the staff appraisal and can join the conclusions in the document, let us focus on the black spot of the overall favorable picture: the very high unemployment, which is at present--and regrettably also for the foreseeable future--a serious problem in the Irish society. The apparent factor behind the poor employment situation is that the economy does not create enough jobs. This seems to have been the situation for a long time, even though emigration has eased the pressure to some extent. Looking ahead, the relative low rate of domestic investment does not bode well for future job creation either.

One of the main reasons for the poor job creation has been the Irish industrial policy, which has favored capital intensive production by multinationals. In the background paper we can see that many of these favored enterprises are only loosely connected to the Irish domestic economy. Hence, in addition to a low direct employment effect their indirect employment creation effect is also not very high. Consequently, from the viewpoint of employment, the so far pursued industrial strategy, where Ireland's "comparative advantage" has mainly been the selectively low enterprise taxation, has not been very successful. Furthermore, this might not be a sustainable strategy in the long run, as this kind of favorable tax treatment could be forced to cease as a consequence of tax harmonizing pressures.

We welcome that the authorities also have recognized this problem, and the planned policy change, where efforts are now under way to create a better environment for domestic firms. The reduction of the still too high tax wedges will certainly lower the obstacles for job creation, but it is unclear if this policy change also includes a change of the 10 percent special low tax rate for the (usually) capital intensive (usually) foreign firms?

Despite the so far announced policy changes one important question still remains: How can the Irish authorities alleviate the difficult employment situation in a situation where unemployment is coming close to its previous cyclical low? In seeking the answer we might look at other nations with a limited amount of natural resources. The most successful and competitive of them has a highly skilled labor force. For Ireland, however, we can see in the recent OECD Survey that in international comparison the quality of education is relatively low. Better education will increase prospects for growth in the long run. But in order to reap the benefits of a better education level there also has to be a genuine change in the industrial policy toward creating a good climate for companies that create permanent jobs. Furthermore the structure of unemployment benefits should be changed, as it seemingly does not encourage young people neither to seek jobs nor education.

However, creating permanent jobs cannot be successful without ensuring a satisfactory competitive situation. Maintaining macroeconomic stability is a prerequisite for long-term competitiveness. Here the exchange rate policy plays a major role. While we fully support Ireland's stability-oriented exchange rate policy, the dilemma is that the Irish pound seems to be rather strongly, and sometimes unjustified, influenced by the pound sterling. Unfortunately, this relationship has not seldom affected the Irish pound adversely, and the authorities have had to support the currency by a tightening of the monetary policy on several occasions. However, as demonstrated by an example from my own constituency the best way to isolate the currency from such unwarranted movements in the long run seems to be through the pursuit of strong and credible financial policies. In this connection I would like to mention that Finland appears to have recently succeeded to loosen the traditional tight connection between its markka and the Swedish krona.

This leads us to another area of concern, namely what seems to be a changed attitude to public spending restraint, as the buoyant revenue development has been channeled into expenditures rather than into accelerated debt reduction. We would find that debt reduction should be preferred to reduction of tax rates, because the debt burden is still extremely high as we can see in Chart 3. Even though the growth rate has been very high, the debt service costs have clearly exceeded the average growth of GNP during more than the past ten years, showing the negative long-run effects of excessive debt buildups. Furthermore a credible fiscal policy is one of the cornerstones for success in other areas of economic policy. Keeping the current fiscal surplus as large as possible, and channeling that surplus into quick debt reduction serve this aim best. Continued decisive debt reduction will also efficiently decrease vulnerability to shocks and give room for policy maneuver when needed. Moreover, the economic upswing is a proper time to reduce the debt quickly as said on many occasions in this Board.

Mr. Evans noted that the Irish economy had performed well over recent years. It had achieved strong growth and low inflation rates and relatively modest fiscal deficits. Against that background, there was a need to assess the position of the economy in the business cycle. While there was no reason to disagree with the suggestion in the background paper that output was a little above trend, the staff's estimates were not without a degree of uncertainty. Economic indicators showed that there had been significant growth in some credit and monetary aggregates as well as some increase in property values. However, it would be difficult to conclude that output was currently much further above trend than it had been five years ago, when there had been an only slightly higher rate of inflation.

The staff report and the background paper devoted a great deal of attention to the exchange rate link between the Irish pound and the pound sterling, Mr. Evans noted. He agreed with Mr. Murphy that the relationship between those two currencies was more significant than the data on export shares would suggest. It was also important to take into account the increasingly European focus of Ireland's aspirations, which permeated a lot of its policies. It should also be noted that the peace process would bring benefits to Ireland as well as to Northern Ireland and the rest of the United Kingdom.

At the present stage, the main policy challenge was the need to address the weakness of the Irish pound in the ERM, Mr. Evans considered. While the Irish authorities clearly considered that weakness to be a matter for concern, their current policy approach, which made good use of the width of the ERM bands, had served the country well.

Looking ahead, the weakness of the Irish pound was clearly not in keeping with Ireland's very strong balance of payments position, Mr. Evans noted. Given Ireland's current account surplus of 7-8 percent of GDP and its capacity to achieve relatively high growth rates, the weakness of the Irish pound could be seen as something of a dichotomy. In these circumstances, Ireland could be expected to be importing more capital than exporting it, although the high level of EU transfers was likely a contributing factor. He agreed with the staff that some reduction of the large current account surplus would be desirable. Although some reduction in the current account surplus might come about naturally as investment picked up, an appreciation of the Irish pound would be beneficial both in terms of keeping inflation rates low and enhancing competitiveness. A recent report by the OECD had conveyed a similar view.

While the fiscal consolidation effort in Ireland over the past ten years could serve as a model for many other European countries, Mr. Evans considered. However, the debt/GDP ratio remained high, and given the current cyclical position, the apparently favorable budgetary position could mask some deterioration in the structural deficit.

Additional fiscal efforts should focus on expenditure, especially current expenditures, Mr. Evans continued. While the authorities' intention to constrain real expenditure growth was welcome, he wondered whether the targeted reduction of expenditure growth of 2 percent was sufficient. It was to be hoped that the authorities would make effort to keep expenditures well within that target.

As to revenues, he agreed with the staff that a further shift of taxation away from labor would be desirable, Mr. Evans went on.

It should be noted that the budgetary position was heavily dependent on transfers from the EU, which amounted to close to 5 percent of GDP per annum, Mr. Evans added. Although transfers from the EU were expected to continue over the next few years, it would be in Ireland's long-term interest to avoid depending on such a high level of transfers, in particular by strengthening the budgetary position.

Despite the staff's analysis, the reasons for the continued high levels of unemployment were not entirely clear, Mr. Evans considered. Nevertheless, it was a structural, rather than a cyclical, phenomenon. In that respect, there was a need for a smaller tax wedge, greater labor mobility, and increased job training. As some recent studies suggested, the lack of competition in product markets might also be contributing to the problem.

Mrs. Wagenhoefer made the following statement:

> Since this will be my last statement in this Board, let me begin on a personal note. The 1993 Article IV consultation with Ireland was the subject of my first Board meeting. We would have a lot less to worry about if more member countries had a fiscal, monetary, and inflation track record like Ireland's.
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> Good performance, like Ireland's, makes the preparation for a Board meeting easy. First, it is much more enjoyable to deal with a success story; and, second, in the bright light of good performance, weaknesses are more obvious. Sticking with a good tradition of concentrating on the areas for improvement, I will focus may comments on Ireland's exchange rate policy, the high level of public debt, and unemployment.
>
> Ireland's major economic policy challenge for the next two years will be to ease and resolve the tension between membership in the ERM and its close links with the United Kingdom, as Mr. Evans pointed out. Ireland is among the countries that have committed themselves to further European economic integration and early monetary union. According to the most recent direction of trade statistics, Ireland's exports into weak currency areas are shrinking as a share of total exports, while exports to hard currency countries in Europe and to Japan are increasing. Meanwhile, Ireland still very heavily relies on the soft currency areas for imports. Viewed from this angle, renewed pressure on these currencies is a blessing in disguise.

Ireland is proving its competitiveness in exports, while reducing its reliance on the United Kingdom, where its cheaper imports help to keep the price level down. The downside risk is, of course, a loss of competitiveness in those low margin traditional exports depending on the United Kingdom's market. Since Ireland probably cannot stay competitive in those areas over the long run, especially if remaining trade barriers protecting Europe are broken down, an early and somewhat forced reduction of the share of those exports in the economy might be advisable, especially since it would take place against a backdrop of very favorable external economic circumstances.

Given the uncertainties about European integration in some of the member countries, the authorities in Ireland will have to prove to markets that their monetary and exchange rate policy is geared toward Europe. An eventual further appreciation against the pound sterling, however, would probably have to be accepted. In this respect, it is pleasing to note from Mr. Murphy's interesting opening statement that "markets seem able to accommodate Irish pound appreciations vis-a-vis sterling more readily."

The other two points I mentioned beforehand are the high level of public debt and the high rate of unemployment. These will also have to be tackled head on if markets are to be convinced of Ireland's commitment to belong to the hard currency core of Europe. Although the debt/GDP ratio is still moving downward, we share the concern expressed by the staff that the current very strong upswing was not used to carry budget consolidation further. Procyclical fiscal policy during an upswing cannot be the first-best solution when saddled with a debt of nearly 90 percent of GDP.

Ireland is seen by many as already fulfilling the Maastricht stock of debt criteria. The authorities will have to be extremely vigilant that changes in the momentarily very favorable external economic circumstances, together with the high rate of unemployment and the heavy debt-servicing burden do not result in a renewed upward movement of the Irish debt/GDP ratio. Even if this were the case only for one year, a strict interpretation of the Maastricht criteria would then very clearly prohibit early participation of Ireland in the EMU, however regrettable such a development may seem to be. The missed consolidation efforts of today will be very sorely missed in the near future.

Since the budget and debt situations preclude the use of fiscal instruments to enhance prospects for the labor market, we fully support the staff's assessment of the structural impediments that have to be overcome to achieve a lasting and noticeable reduction in Ireland's high unemployment rate.

Mr. Prader made the following statement:

The performance of the Irish economy is impressive in many ways, but especially in terms of overcoming the recession, achieving strong growth and a huge current account surplus as well as lowering inflation. The authorities' strict and continuous fiscal discipline in recent years has been a decisive ingredient of this outcome. Starting from an apparently almost hopeless situation just a few years ago, Ireland has made great strides in reducing its public debt, has met the important Maastricht criteria, and seems well poised to be among the first entrants into the economic and monetary union, subject of course to a favorable interpretation of the debt criterion. These accomplishments have demonstrated that the Maastricht criteria are achievable, provided a country's authorities have the patience and fortitude to steer a steady course of prudent fiscal and monetary policy. Nevertheless, Ireland's major problem remains unsolved: its high, persistent, and seemingly intractable unemployment.

Unless it is exploited in a careful and timely manner, sustained fiscal success can prove to be its own undoing: it generates impatience and may give rise to demands for higher expenditures and lower taxes. Ireland's recent strong growth in expenditures is a case in point, and every effort should be made to reverse it. I have taken note of the recently announced measures aimed at medium-term expenditure restraint but perhaps the target of holding expenditure growth to an average annual growth of 2 percent in real terms is not ambitious enough. In view of the economy's extraordinarily high growth rate and the apparent strength of the private sector, it should certainly be possible to get by with a smaller fiscal stimulus, both in terms of holding public spending to a slower growth rate and in terms of not reducing tax rates.

I am inclined to agree with Ms. Srejber that debt reduction is preferable to tax cuts. Even though the debt stock has declined faster than expected, the fact remains that the public debt is still extremely high; and even though Ireland will probably meet the Maastricht budget deficit criterion with ease, it is by no means close to the general debt target of 60 percent of GDP and therefore needs to pursue debt reduction more aggressively than other potential core candidates for the economic and monetary union. The Government can certainly not afford any slowdown in the rate of debt reduction but should seize the present opportunity to move faster.

It is an interesting novelty to encounter a central bank that makes much more optimistic growth forecasts than does the Ministry of Finance. In view of the Central Bank's extremely high growth assumption of almost 6 percent, it is somewhat puzzling that the monetary authorities cannot agree with the staff on a tighter monetary stance. Notwithstanding the high unemployment rate, which seems to have a structural origin, such a scenario of very high growth already suggests overheating and calls for a tighter monetary policy.

Mr. Murphy indicates that the monetary authorities might tighten their policy later on, in the course of Ireland's upcoming accession to the economic and monetary union, but the present monetary stance can also be seen as an expression of the Irish currency's ambivalent position between the ERM and the British pound. As long as Irish exchange rate policy is being pulled in contrary directions by its quasi-schizophrenic loyalty to two currencies at once, it is likely to be exposed to repetitive testing by the markets. Ms. Srejber has pointed to the case of the Finnish currency, which has loosened its connection with the Swedish krona through credible fiscal and monetary policies. If the comparison with Finland is relevant, and I have read Ms. Srejber's mind correctly, this probably implies a tighter monetary policy in Ireland to overcome the current weakness of the Irish pound and to bolster its European monetary aspirations. I therefore agree with Mrs. Wagenhoefer that an eventual appreciation of the Irish vis-à-vis the British currency will have to be accepted.

One final remark, on state enterprises. We welcome the progress in restructuring these enterprises and establishing commercial benchmarks for their performance. However, the experience of most countries with large nationalized industries shows that even these well-meaning reforms fall short of what could be achieved with a change in ownership. In the longer run, even reformed state enterprises will not be able to overcome the fundamental problem of state enterprises, namely their dependence on the Government, which is to say their reliance on non-economic performance criteria in times of stress. Such causes as economic efficiency, the state budget and Ireland's economic competitiveness would all be better served if the Irish Government were now considering extensive privatization.

Mr. Evans commented that the similarities between Finland's relationship with Sweden and Ireland's relationship with the United Kingdom were limited in scope.

He agreed with the comments put forward by Mr. Prader on the need to pursue privatization as a means to improve overall competitiveness, Mr. Evans said.

Mr. Coumbis made the following statement:

We congratulate the authorities, as we have done in previous years, for the policies which have been followed in 1994 and again in 1995. In fact, the results continue to be impressive: the rate of GDP growth is the highest in the EU while the inflation rate is lower than the EU average and the external current account has registered a sizable surplus. Moreover, fiscal consolidation continues to be a key fiscal policy objective as evidenced by the relatively rapid deceleration of the debt-to-GNP ratio and by the fact that Ireland is one of two EU countries not included in 1994 under the Maastricht Treaty's excessive deficit procedure.

Of course, there are a number of concerns connected with the high unemployment rate, the implementation of the 1995 budget, the restructuring and privatization of public enterprises, and the turbulence in the foreign exchange market in the first months of 1995.

With respect to unemployment, it should be noted that the rate of unemployment decreased in 1994 only to 14.8 percent, despite the fact that GNP growth exceeded 5 percent, and employment increased by 3 percent, and that the authorities initiated a series of programs, especially in the area of training, in order to confine long-term unemployment and to create lasting jobs. Furthermore, they undertook a series of tax reforms aimed at reducing the tax burden imposed on job creation and encouraging employment creation by enterprises. In trying to explain the persistence of high unemployment, we should take into account the rapid growth in the labor force and the fact that the export-oriented foreign enterprises which are substantially contributing to the high GNP growth rates are labor saving enterprises. Emigration has eased the problem, but has not solved it.

To further decrease unemployment, the authorities should, according to the staff, take additional measures, beyond those already taken, to reduce the high replacement ratio and tax wedges, to increase the flexibility of work practices and relative wages, and to narrow the bias against the labor-intensive indigenous service sector.

I am in agreement with the staff with respect to their call for the authorities to reduce replacement ratio and the tax wedge.

I urge the authorities to take more decisive steps in that direction. It seems that, in this area, there is still much room for improvement, through the reductions of disincentives to work. With respect to the flexibility of work practices and relative wages, I would like the staff to be more specific about the measures they have in mind in this area. On this point, I would like to stress the authorities view that "centralized wage agreements negotiated with he main social partners is an essential tool to ensure wage moderation and help reduce unemployment." It seems, moreover, that in such a centralized wage agreement there were no minimum wage provisions.

As for the staff's suggestion to narrow the bias against the labor-intensive service sector and the authorities' promise that efforts are under way to shift the emphasis of industry policy toward domestic firms, I would appreciate some comments from the staff or from Mr. Murphy concerning the specific measures that the authorities intend to implement in order to narrow the gap with domestic firms, taking into account that the tax incentives to foreign multinational firms cannot be repealed before 2010.

Assuming that the planned measures include some type of tax incentives and the restructuring and or privatization of state monopolies--in order to reduce the cost of their services to domestic enterprises--I would like to stress the following point. It is clear from the staff report that in order to provide tax incentives to domestic enterprises and to restructure public enterprises, it is necessary to restrict public budget expenditure and to follow, for the period 1996-97, the two percent containment of non-interest, current expenditure growth without any deviation. I was pleased to see from the staff supplement that, in fact, the authorities are already taking measures in order to achieve the two percent target in 1995. I agree with the staff that these early actions will enhance the authorities' credibility with respect to the tight expenditure policy.

This brings us to the area of fiscal policy in 1994 and beyond. As we have already said, fiscal adjustment in Ireland in the last few years was quite successful. In 1994, however, as we have already said, there some slippages in that year's budget. I agree with the staff that the authorities, through the adoption of an expansionary budget in the midst of an upswing, have missed the opportunity of greater progress as concerns debt reduction.

The medium-term outlook present by the staff in the background paper is a very useful exercise. It is clear therefrom that if the authorities want to continue tax reforms, aimed at reducing tax impediments to job creation, and if they also wish to attain the Maastricht target of a 60 percent debt-to-GDP ratio early in the next century, they must continue containing real, non-interest current expenditure growth to two percent per annum through 2001.

Finally, I would like to address the exchange rate turbulence at the beginning of 1995. The staff suggests that the authorities should keep the Irish pound's deviations from its central rate as little as possible in order to maintain their credibility concerning their objective of price stability and of being among the first countries to enter into the EMU. In the staff report, it is noted that during March 1995 the Irish pound was at or near the bottom of the ERM grid. The authorities increased interest rates after the March turbulence, and this contributed to the partial recovery of the Irish pound against other narrow-band currencies, and to a gradual appreciation against the pound Sterling. However, from the staff supplement we can see that, in recent weeks, the Irish pound has remained at the bottom of the ERM grid. The staff, therefore, suggests tighter monetary policy while the authorities, for reasons clearly explained in Mr. Murphy's statement, prefer to wait for further evidence of an impending surge of inflationary pressures.

I am convinced that the authorities are committed to the maintenance of price stability and to early membership in the EMU. Furthermore, if they have further evidence that credit growth has failed to moderate or if price pressures have manifested themselves, the will increase STF rates and tighten monetary policy without delay.

Mr. Wire made the following statement:

As the staff and just about everybody else have noted, Ireland's economic performance in 1994 was, once again, quite good. With continued sound policies, Ireland should be able to sustain the pattern of strong growth and low inflation seen over the past several years. However, some tinkering is needed to improve the capacity of the economy to create jobs and absorb external shocks, as well as to reduce the still high level of public debt. In this regard, we fully share the staff's analysis and recommendations concerning the priority issues facing Ireland, which we see as the need to reduce unemployment, improve public finances, and increase domestic investment. As a longer-term issue, of course, Ireland's stance on exchange rate policy and the regime associated with it may need to be clarified as well.

On fiscal policy, we join others in welcoming the better than expected performance on the deficit and the reduction in public debt, along with the expectation that further reductions in the level of general government debt are to be expected in 1995. However, while the level of debt has come down quite rapidly, it is still quite high, and it seems to us, as others have mentioned, that the economy ought to be able to support a faster pace of debt reduction than is currently envisioned. In this regard, we would join others in regretting the opportunity that Ireland seems to be passing by at the moment. It could be capitalizing a little bit more on the progress made last year. As it is, the pace of expenditure increase seems far too rapid to us, and even the two-percent ceiling for 1996 and 1997 is, in our view, definitely unambitious.

Like others, we would prefer to see a much stronger effort made to control current spending, particularly in the area of social welfare expenditures, public sector wages, and I would also cite transfers to enterprise, which I think the staff noted to amount to about half-of-one percent of GDP. Overall, like Mr. Evans and others, we would like to see the Government go below the two-percent real increase for 1996 and 1997, perhaps targeting zero real increase.

On the revenue side, while important reforms are underway, the Government still needs to tackle the large biases in the tax code that are inhibiting job-creating activities, including the corporate tax differential. Like Ms. Srejber, we would be interested to hear whether and how this might be accomplished. However, the focus should be on ways to reduce the tax wedge and the tax burden faced by domestic firms and by policy changes to spur competition in domestic investment, and not by changing the tax system and the "preferential treatment" that applies to existing investors.

Turning to critical structural issues, despite the welcome gains in employment and the smaller reduction in unemployment seen in 1994, we, like Ms. Srejber in particular, think the very high rate of unemployment is a real cloud over Ireland's relative economic success. Much more needs to be done to remove the tax distortions and reform the features of the labor market that are perpetuating the unemployment problem. That would include looking at the costs and benefits of centralized wage setting perhaps in a more serious fashion. We welcome the various efforts that are underway to reform the labor market, but would also agree with almost all of the staff's recommendations about other needed reforms in this area.

Turning to the public enterprise sector, while it is encouraging to hear that modest reforms are underway to improve the operation of public enterprises, we are quite disappointed that the Government continues to rule out any effort to privatize state holdings, much less develop any sort of a clear strategy for full privatization, and here I would fully agree with the comments made by Mr. Prader and Mr. Evans, in particular. This policy stance seems shortsighted to us and really ought to be reconsidered, as it is really at odds with the need to improve public finances, increase economic efficiency, and spur job-creating private sector activities.

On monetary and exchange rate policy, I tend to agree with Mr. Evans' observation that the current account surplus is too large and Ireland ought to be, on balance, a capital importer. But given the absence of significant effective appreciation in 1994 and the large current account surplus, it seems to me that the currency has been quite competitive. Therefore, we would tend to agree with the staff that there is some room for appreciation at the moment. However, with regard to the longer-term question of the exchange rate regime that is appropriate for Ireland, we are not sure it would make sense for Ireland to aspire to exactly the same sort of policy followed by other small open economies in the ERM, such as the Netherlands, of tracking the deutsche mark within the former narrow band. While the U.K.-Ireland economic relationship may continue to diminish somewhat over time, it does not seem that the punt can escape the random disturbances in both directions that may be caused by developments in the pound-deutsche mark relationship.

Finally, on statistical issues, we appreciated the helpful matrix provided on the final page of the staff report. It does seem that development of more frequent CPI and GNP series would improve efforts to manage the economy, and we would appreciate comments from the staff as to whether this is contemplated.

Mr. Cailleteau made the following statement:

Let me at the outset indicate that I welcome the emphasis in the "policy discussions" on monetary and exchange policy. This is, in the case of Ireland, an intricate question which deserves a great attention.

I won't dwell on fiscal policy since I understand that the authorities recognize that the pro-cyclical stance is not sustainable. This remark, however, should not cast any shadow on our overall long-term assessment of fiscal policy in Ireland, which remains a case-book experience, as highlighted in the impressive Chart on national debt/GNP.

I will focus my remarks on monetary and foreign exchange policy: I must say that, even if I have some sympathy for the staff's inclination towards monetary tightening and foreign exchange stability, I am not sure they have made their case strong enough at this stage.

Let me first of all welcome the European fervor of the staff which advocates a monetary tightening to bring the exchange rate in line with its central rate in the ERM. Such an objective is indeed appropriate in its own right; what is still, however, open is the pace of the adjustment: our position is that the speed of the convergence towards the central rate must be stalled against fundamental macro-economic requirements, such as the inflationary pressures and the competitive position.

I don't find in the report very decisive arguments concerning the risk of unsustainable inflationary pressures; I believe more focus on relevant advanced indicators should have been helpful. Concerning the use of the output gap, I understand that Mr. Murphy downplays the relevance of some indications given in the background paper; I would be interested to have the opinion of the staff on the usefulness of such an indicator in Ireland.

As regards competitiveness, the staff makes the case that there is some scope for the Irish pound to appreciate in the ERM grid. I was very interested by the background paper on the Irish pound-sterling exchange rate.

I draw from that development the following conclusion:

It is very useful to move beyond the mere analysis in term of actual real exchange rate to have a comprehensive understanding of the link between exchange rate and competitiveness; I cannot but agree that, for instance, if productivity is going faster than abroad, the resulting real exchange rate appreciation is not incompatible with an equilibrium of current account. The analysis of the determinants of Ireland's equilibrium real exchange rate with sterling is therefore very helpful; the degree of overvaluation must indeed be judged in reference to the equilibrium real exchange rate whose determinants are inter alia the terms of trade, the relative productivity growth and, interestingly, the rate of fiscal consolidation.

I will, however, make two qualifications as far as our policy recommendation is concerned:

The first one is that, provided that this analysis is correct (and I think it is), what matters is to convince the market of its relevance. The market seems, for the time being, still excessively attracted by the prominent explanation linking "actual" real exchange rate appreciation to overvaluation, and then to lack of competitiveness.

The second one is associated to the underlying notion of adjustment lags (between the actual and the equilibrium real exchange rate): the reaction of the market is immediate; the cost, in term of price competitiveness, of a nominal appreciation of the currency is immediate; on the contrary, the factors at play in the determination of the real equilibrium exchange rate need some time to produce their effects: productivity, fiscal consolidation in particular.

Therefore, I believe the adjustment of the real economy to a nominal appreciation takes some time and I understand the progressiveness of the authorities policy stance. Overall, I believe that, given the rather substantial spread on interest rates vis-à-vis Germany, monetary policy in Ireland tries satisfactorily to reach "un juste milieu".

Mr. Murphy commented that he agreed with the conclusions contained in the section of the staff report on the equilibrium exchange rate of the Irish pound vis-à-vis the pound sterling. He could also agree with the comments put forward by Mr. Cailleteau on that subject.

Mr. Fernández made the following statement:

First of all, let me congratulate the Irish authorities for the impressive performance of the Irish economy. I will make some remarks on three issues also raised by Mrs. Wagenhoefer, although I am afraid I will express different views from hers.

Regarding the fiscal situation, it is clear that the EU Council of Ministers does not consider Ireland to have an excessive public sector deficit, in other words, Ireland complies with the excessive deficit criteria. Therefore, I do not see the point of raising this issue here. A different issue is to express the view that the fiscal policy is not restrictive enough, all things considered. In view of the huge amount of net transfers from the EU received every year by Ireland, in terms of GDP, the concept of surpluses of the flow fiscal position should have some meaning, especially if it is suggested, as the staff does, that these transfers can be reduced in the future.

I will turn now to the unemployment problem, just to say that Ireland is a good example of a country that considers monetary and financial stability as a necessary condition for growth and employment. As a consequence, it is difficult to argue that the credibility of Irish stabilization policies is in danger due to the high unemployment rate. Unemployment is a very important matter of concern for all EU governments, but nobody should expect unilateral actions to tackle this problem putting at risk domestic monetary and financial stability.

The third issue I wanted to mention is related to the exchange rate policy dilemmas faced by the Irish authorities. I found the background study of the staff on this issue very informative. This study confirms the strong dependency of the Irish pound on the pound sterling. The 10 percent realignment episode of the Irish pound in February 1993 was disappointing because it showed the weakness of the cooperative arrangement that the EMS was supposed to be. Ireland deserved the support of the EMS, but it did not get it. This episode raises questions, in my mind, about the sustainability of the Irish pound in an irrevocably fixed exchange rate system, previous to the single currency, without the full participation of the pound sterling. Alternatively, such a system, if it is something more than a mere set of unilaterally adhered members, should have at hand credible instruments to keep within the system currencies submitted to external shocks. Like the U.S. chair, I also think it is important to explicitly talk about these problems in the Fund. A study by the European I Department on this matter is needed.

The staff representative from the European I Department noted that the Irish authorities had made a public commitment to maintain the tax on profits in manufacturing and certain international financial services at the rate of 10 percent through 2010. Therefore, any benefits that could be derived from changing the rate of that tax would be offset by the costs to the authorities' credibility. Meanwhile, the authorities' strategy was to focus on reducing the standard corporation tax rate applied to nonmanufacturing activities. In the context of the 1995 budget, that tax rate had been reduced from 40 percent to 38 percent, and the authorities planned to reduce it further in the future. The staff agreed with the authorities that further cuts in that tax rate would be beneficial.

While the lack of competition in product markets was a factor in the high rate of unemployment in Ireland, the staff considered that it did not play as large a role in the unemployment problem as some other factors, such as the high tax wedges and replacement ratios, the staff representative said. Nevertheless, it would be important to improve the climate for private investment through public enterprise reform, privatization, and the adoption of a strengthened competition policy.

According to a recent study by the Organization of Economic Cooperation and Development (OECD), the unemployment problem in Ireland was, to a much greater extent than in many other European countries, attributable to a lack skills, the staff representative stated. That problem related both to older workers, whose skills had become redundant and to unemployed school leavers, who lacked sufficient training and qualifications. On the basis of that study, the OECD had recently made a number of recommendations on ways to address the unemployment problem, and those recommendations were currently under active consideration by the Irish authorities.

Other contributing factors to the level of unemployment were issues related to the flexibility of working practices, such as opening hours and job-sharing arrangements, the staff representative commented. For example, a large department store chain that was planning to open on Sundays was currently facing some difficulties in negotiations with its workers.

To the staff's knowledge, the authorities were not planning to alter the frequency of data on the consumer price index or the national accounts, the staff representative said. The consumer price index had been published on a weekly basis in the years prior to 1970. However, during a period of sharply rising inflation rates, the authorities had adopted the current practice, under which the consumer price index was compiled for the middle month of each quarter.

The output gap indicators presented in the background paper should be considered as tentative, the staff representative noted. In the case of Ireland, it was not possible to use the production function approach, owing to the lack of a comprehensive series on capital stock and the difficulties in projecting the growth of the labor force--given the volatility of immigration and sharp changes in participation rates. Therefore, the staff's analysis of the output gap had relied on the HP filter and the segmented trend method. On that basis, the staff analysis showed that output was currently above trend.

Private sector credit growth had increased from about 15 percent in March 1995 to about 17.5 percent in April 1995, the staff representative noted.

As to the possible analogy between Finland's relationship with Sweden and Ireland's relationship with the United Kingdom, it should be noted that the share of Sweden in Finland's trade was much lower than the United Kingdom's share in Ireland's trade, the staff representative from the European I Department said. Thus, the two relationships were not truly comparable.

Ms. Srejber noted that the link between the currencies of Sweden and Finland was stronger than indicated only by the share of Sweden in Finland's trade, owing to the competition between those countries in third markets. The lesson to be drawn from that relationship was that, even with currencies that had been closely linked, a country should be able to achieve a delinkage through the pursuit of appropriate policies.

Mr. Murphy said that the recent study by the OECD on education had been based on a very complex set of indicators that did not clearly lead to firm conclusions about specific countries. Indeed, the indicators used in that study required careful interpretation, and the manner in which they should be interpreted was currently the subject of a great deal of international debate. For example, while the Irish had compared unfavorably with nationals of other countries in the areas of science and mathematics at very young ages, the testing had been applied to an age group for which science and mathematics were not taught in Ireland. Nevertheless, at older ages, Ireland had produced a higher proportion of technical graduates than any other country included in the survey, except Japan.

Also, it was not easy to apply the questions concerning education to the unemployment situation in Ireland, Mr. Murphy considered. The core of the long-term unemployed in Ireland comprised older workers with a low level of qualifications. Indeed, one of the reasons that long-term unemployment was proving to be an intractable problem was the difficulty of getting that group back into employment.

Although the rate of unemployment in Ireland remained high, it should be noted that employment was growing sharply, despite the significant downturns in employment in agriculture and public service over recent years, Mr. Murphy noted. Employment in services had been increasing over the past five years at about twice the rate of employment in industry. While there was clearly a need for structural reform with respect to the labor market, it was also important to strike an appropriate balance between the need to increase employment and the need to maintain a stable fiscal balance.

Structural rigidities, such as Sunday openings, were not a significant problem in Ireland, Mr. Murphy stated. While one of the large department stores was encountering difficulties in negotiations with its workers, those difficulties were not related to the proposal to open on Sundays, but to the fact that the store gave its employees zero-guaranteed wage contracts, which did not even provide for a definite number of minimum hours per week employment. Ireland had had Sunday openings on a nonstatutory basis for the past five years.

Mr. Gaspard made the following statement:

I join other speakers in congratulating the Irish authorities on a strong domestic and external economic performance that, since 1990, has surpassed that of the EU on average. However, challenges remain, particularly on the fiscal and unemployment fronts. I therefore also join the staff and other speakers in voicing concern about the procyclical stance of the 1995 budget, especially as the underlying inflation rate has reached the Central Bank's upper limit of 3 percent, and notwithstanding the authorities' welcome commitment to contain non-interest current expenditure to 2 percent in real terms during 1996-97. I must add that the recently issued details concerning this commitment to future expenditure restraint will surely enhance the credibility of the authorities' stabilization policy.

I agree with the staff appraisal, and find its call for containing the expansion in expenditure, at a time of strong growth in output and credit demand, to be justified. The need to give priority to fiscal tightening is made especially evident by Ireland's still very high debt ratio, despite recent notable improvements, and by the limited margin of maneuver the authorities have in their exchange rate policy. The authorities are indeed committed to exchange rate stability, through an announced objective of variation in the exchange rate of the Irish pound within a narrow band in the ERM. This would clearly shift some of the adjustment burden on both monetary and fiscal policies.

While the authorities have expressed concern about the possibility of an eventual adverse effect resulting from an increase in interest rates on domestic activity where a high proportion of credit is extended at variable rates, I believe the staff's call for further monetary tightening in view of the continued strong credit and overall domestic demand merits the authorities' consideration. On fiscal tightening, I would merely emphasize, in addition to my previous comments in this regard, that significant progress in public enterprise reform and privatization should greatly assist the fiscal consolidation efforts of the authorities in a more tangible and durable manner. Finally, the high degree of openness of the Irish economy, together with the announced narrow band for the Irish pound, can only reinforce the argument for added emphasis on fiscal effort.

My last point concerns the issues of investment and unemployment. The recent strong growth in employment and the fall in unemployment since 1994 should not obscure the fact that the unemployment level in Ireland remains high and may be further exacerbated by the rising female participation in the labor force, which, at slightly less than 36 percent in 1994, still has a long way to rise to the European average of approximately 53 percent. Moreover, although the domestic and external economic performance in Ireland has been overall constantly superior to the average in the EU over the past five years, the investment and unemployment performance has distinctly lagged behind for an even longer period of time. Ireland thus needs a sustained strong boost in its domestic investment, which could simultaneously sustain the reduction in unemployment levels. The impediments appear to lie mainly in the structural domain and would call for an increase in labor market flexibility and the reform of the tax system and public enterprises in a way that would lower business costs to domestic enterprises. The overall positive performance of the Irish economy now affords the authorities a unique opportunity to stimulate domestic investment and employment without doing much prejudice to their stabilization objectives. This opportunity should be seized, especially in view of Ireland's favorable competitive position and its large external current surplus in particular, noting that the transfers from the EU are expected to decline after 1999.

Mr. Fukuyama made the following statement:

As the Irish economy is in relatively good shape, I will limit my comments to some key issues.

I note that the staff, not the authorities, argues for the exchange rate in line with its central rate in the ERM. This is interesting, as the early entry into economic and monetary union is, in a sense, a political matter to which the country concerned, rather than the Fund, pays much attention. In any case, I feel sympathy with the pragmatic approach the authorities took in March, in the face of the declining Irish pound. Considering Ireland's perceived close relationship with the United Kingdom, whether or not it is fully justified, the cost of inducing a sharp appreciation of the Irish pound against sterling would have been considerable. My understanding is that the wider band was introduced in order to deal with these circumstances.

However, if the staff argues that higher interest rates are warranted in light of the estimated disappearance of the output gap in Ireland, it is a different story. Indeed, there seems to be room for further tightening, in order to maintain low inflation, irrespective of its effects on the exchange rate.

From this viewpoint, however, fiscal policy is more a source of concern than is monetary policy. Although the authorities' emphasis on tax reform is understandable, the procyclical nature of fiscal policy is problematic. Indeed, the slow-growth and higher-interest-rate scenarios presented in the background paper are both possible, and the starting point of the Exchequer borrowing requirement should therefore be lowered as much as possible. I join the staff in advising the authorities to specify expenditure restraining measures at an early stage, and I welcome the step taken by the Minister of Finance on June 8.

On unemployment, I broadly share the staff's views, but would like to add one point. Chart 2 of the staff report gives the impression that there is room for encouraging higher domestic investment in the medium term. If, as the recent World Economic Outlook suggests in Box 4, higher domestic investment is capital "widening" rather than capital "deepening," that will help to increase employment. The issue is how to secure capital "widening"; the World Economic Outlook underlines restrained real wages and labor market flexibility as key factors. From this viewpoint, too, I think that the staff's call for increased labor market flexibility in Ireland is relevant.

Mr. Himani made the following statement:

One can only complement the Irish authorities for their skillful policies that have contributed to the economy's impressive performance over the past few years. I am in broad agreement with the staff appraisal and will therefore limit my remarks to two issues:

First, the staff presents very valid arguments in favor of a modest appreciation of the exchange rate closer towards its central parity within the ERM. Mr. Murphy's statement has clarified the authorities' intentions regarding exchange rate policy which I understand as being fully consistent with the objective of early entry into the EMU. It may be true that market perception regarding the authorities' tolerance of an exchange rate appreciation vis-à-vis sterling is mistaken. However, as the destination of Irish exports diversifies further, market perception of a strong link between the Irish pound and sterling is bound to weaken. Furthermore, while some exchange rate movements may not have been justified by fundamentals, the exchange rate is not out of line. It is important not to engineer exchange rate movements for which there is no compelling or overriding need in the near term that will be counter to popular perceptions and are bound to be tested by the markets.

Second, while the authorities have been very successful in their fiscal consolidation efforts and in reducing the debt burden, the challenges in the areas of fiscal and structural reform remain considerable. In particular, Ireland has been in compliance with the Maastricht criteria and has taken a number of steps to reduce distortionary elements in the tax system that have contributed to the high rate of unemployment. Nevertheless, the procyclical nature of fiscal policy and the continued high level of unemployment are a source of concern. I share the staff views in this area, in particular regarding the needed reforms in the tax system. I also hope that the authorities would place greater emphasis on reducing the overall size of the public sector. Such a reduction could only support the authorities' objectives of promoting private sector activity and reducing the rate of unemployment.

With these remarks, I wish the authorities continued success.

Mr. Obame made the following statement:

Since success story cases are becoming rather rare "species" in this new integrated world economic environment, Ireland could be considered among those, although the high level of unemployment is a cause for concern.

Like other speakers, we commend the Irish authorities for the continued good macroeconomic performance achieved so far, owing to the pursuit of financial discipline and an outward-looking economic strategy.

As indicated in the staff report, output growth expanded sharply in 1994 and remained well above the OECD average, inflation was low, the unemployment rate declined somewhat although still very high and the external current account surplus widened.

Looking ahead, and based on current projections, it appears also that over the medium term, the Irish economy would continue to perform well. This, indeed, only underscores that the three pillars on which the authorities have so far put emphasis in managing their economy, namely, price and currency stability and fiscal discipline are appropriate and should continue to be given priority.

Having said that and since I endorse the views expressed by previous speakers as well as the staff appraisal, let me just make some comments on one issue of concern where emphasis and continued efforts are needed, namely, the unemployment situation.

At close to 15 percent in 1994, the unemployment rate remains too high and needs to be forcefully reduced. We are encouraged by the fact that this issue is indeed one of the main priorities on the authorities' agenda. In this context, we welcome the fiscal measures adopted in the 1995 budget and aimed at reducing the tax burden imposed on job creation and at promoting enterprise development. Moreover, while welcoming the continued implementation of the multi-year centralized wage agreement negotiated with the social partners, and which has contributed to ensure wage moderation, we also welcome the specific initiatives that are being undertaken to promote longer-term employment. In particular, and given the fact that unemployment seems to be concentrated among those with limited skills, we see great merit in the training and placement programs, whereby employers are encouraged to provide opportunities for employees to upgrade skills.

However, even with the implementation of these measures, it would seem that the unemployment situation will remain acute in Ireland for some time to come, as the expected continued rapid growth in the labor force that will be exacerbated by the rising female participation, will not be compensated by the rate of employment generation. This is indeed a dilemma that we expect the authorities will succeed to resolve so as to prevent and mitigate social tensions in the future. One way, among others, to address this issue, would be to increase domestic investment which seems to be low, so as to continue to spur growth and create more jobs. In this regard, we agree with the staff's suggestion that it would be desirable for the authorities to consider reducing the large external surplus through higher domestic investment.

Finally, like the staff, we are encouraged by the authorities' intention to make progress toward reaching the UN goal for ODA.

Mr. Wei made the following statement:

Since the last consultation, the Irish economy has continued its robust growth and obtained a general macroeconomic stability, despite currency turbulence in the early part of this year. The overall competitiveness and growth prospect for the economy in Ireland also seem strong and favorable over the medium-term prospective. Nevertheless, as the staff clearly points out in its paper, some concerns exist with regard to currency stability, further fiscal discipline and reduction of high structural unemployment.

The three pillars emphasized by the authorities--price stability, currency stability and fiscal discipline--focus on these concerns. They are inter-related elements necessary for achieving the objectives of promoting competitiveness, growth, and employment.

Given the economy's openness, currency stability is important. The authorities rightly reacted to the March turbulence with an increase in interest rates and intervention. However, as for future operations, we share the staff's concern that it is not quite clear as to how the authorities will be able to pursue a policy of currency stability and low inflation if they are reluctant to use interest rates to follow the Deutsche mark or other former narrow band currencies. The authorities are concerned that currency appreciation in the domestic economy may affect their close trade relations with Britain. It seems that this dilemma has made the authorities more dependent on the ERM performance than their own policy.

Given this monetary dilemma, it appears necessary that the fiscal policy make a greater contribution to macroeconomic stability. Despite progress in reducing the public debt, the still-high public debt level remains a source for concern, possibly making the economy vulnerable to external shocks. Moreover, the general government deficit in 1995 has increased, due to unanticipated factors. We note the authorities' commitment to containing current expenditure growth, and support the staff's suggestion of further progress in expenditure restraint, as well as a medium-term tax reform and expansion of the tax base.

Turning to structural issues, it is obvious that the high level of unemployment continues to be the central challenge for Ireland's economic policy, notwithstanding a growth in jobs created in the private sector. The authorities have taken some initiatives to address this issue, some of which have been far-reaching measures. We believe that wage rigidity is the fundamental factor impeding the smooth functioning of the authorities' labor market, and that changes in the current wage-setting process will benefit the authorities in the long run.

The relatively low growth of domestic investment is another source for concern. We share with the staff the view that policies encouraging competition would help address this issue.

Finally, let me say again that we commend the authorities' good performance, and wish them success in addressing the above-mentioned difficult policy challenges.

Mr. Vernikov made the following statement:

We support the main points of the staff appraisal concerning Ireland's successful performance in recent years. The country maintained strong economic growth together with an enviable price stability, which resulted from disciplined and responsible policies. It appears that markets duly appreciate these developments by narrower interest rate differentials.

It is true that the level of public debt is still rather high in Ireland. However, the Irish authorities need to be commended for their efforts to deal with the debt problem. In nominal terms, growth of the stock of debt outstanding slowed down, and as a proportion to GDP, it fell continuously from almost 134 percent to 112 percent over the past five years. Reduction of the external debt burden was particularly successful. The resulting downward trend in debt servicing is already starting to produce a positive effect on the budget. I believe that Ireland sets a positive example of how to solve the public debt problem, and in any event it shows that even high levels of indebtedness are reversible, provided that policies are strong and responsible.

I would mention just one more issue: by 1984, the foreign currency component of debt was larger than the domestic one. During the period of fiscal stabilization, its share was reduced, although it rose in 1992 because of the punt depreciation. The currency composition of this component of the debt underwent considerable changes. In this connection, I wonder what are the lessons that can be drawn from the Irish experiences in managing foreign currency denominated public debt. It may be relevant to some transition economies where authorities from time to time look at this instrument.

Mr. Mucibabici made the following statement:

Developments in the Irish economy over the period 1993-95 are indeed positive, as the staff rightly remarks in its well-structured paper. Real growth has recorded increasing levels and inflation has further decelerated, while international reserves have risen significantly. This progress could not have been realized without the authorities' sustained policy actions, initiated in the late 1980s, on both the monetary and fiscal fronts. Therefore, on this occasion, as in 1994, we commend the authorities for their continuous progress toward their major objective: a rapid integration in the economic and monetary union.

The outcome is even more encouraging than a year before, as significant headway has been made in the areas of unemployment alleviation, overall deficit containment, and further outstanding debt reduction. However, the domestic investment and fixed capital formation/GDP ratio are still below the EU average. Thus far, buoyant Irish exports have been largely fueled by the increasing number of high tech industries established with direct foreign investments; as the tax facilities for foreign investors might be reduced in the longer run, the possibility of a decline in foreign investment should be taken into account. Therefore, several structural problems should be addressed, in order to foster strong sustainable economic growth based on domestic fixed investment, and thus reduce the still-large unemployment ratio, 14.8 percent of the labor force in 1994. In this respect, the authorities' effort to provide training for, and encourage job searching by, the long-term unemployed is a step in the right direction. Nevertheless, as noted in the staff report, the high level of structural unemployment calls for additional action.

On the budgetary front, Ireland is also ahead of many other potential members of the economic and monetary union. Therefore, it was not cited under the excessive deficit procedure of the Maastricht Treaty in 1994 and 1995, owing to the reduction of the debt/GNP ratio, from 123 percent in 1988 to 94 percent at end-1994, and to a general government deficit below 3 percent of GDP. Nevertheless, we share the reservations of the staff about the adoption of an expansionary budget in the midst of an upswing. Thus, we welcome the authorities' announcement of a policy of slowdown in the growth of the government expenditures to 2 percent, in real terms, during 1996-97. The objective will be difficult to realize, in view of the fiscal implication of several contingent liabilities. Moreover, further expenditure restraint is needed to keep the deficit and public debt within the Maastricht criteria after 1999, at which time the inflows from the EU may be substantially reduced.

As regards monetary policy, we see the authorities dilemma of choosing between the objective of having the Irish pound perform at least as well as other former narrow band currencies or keeping its traditional link to the sterling. However, we agree with the staff that, for an early entry in the economic and monetary union, a progressively greater weight should be given to bringing the exchange rate back in line with its central rate in the ERM. Considering the strength of the upswing, a slight appreciation will presumably not affect the domestic economy.

In view of the importance of future market developments and the need for an appropriate management of the still-large outstanding government debt, we welcome the intentions of the Irish bond-markets supervisors to enhance its liquidity, depth, and performance by creating a primary-dealers institution. We also agree with the staff recommendations as regards a cautious approach to the issue, in terms of responsibilities imposed versus prerogatives granted.

As regards structural reform, we would like to emphasize two issues. One is the costly public enterprises--in terms of transfers for their deferred liabilities--and the other is the need for a faster privatization of some government assets. Both will ease the burden on the budget, and therefore will help the achievement of the authorities main goal: expenditure restraint.

The staff representative from the European I Department noted that Ireland's successful efforts to reduce its high external debt denominated in foreign currencies might provide lessons for other countries, including economies in transition.

Mr. Fernández asked whether the staff could comment on the conditions that would be required for the Irish pound to participate in a fixed regime with other European currencies on a sustainable basis.

The staff representative from the European I Department responded that he would not wish to pre-empt the requested staff study on Ireland's participation in the ERM. Nevertheless, the historical time series data contained in the background paper showed that there had been a considerable change in Ireland's relationship with the United Kingdom over time. While Ireland had developed much closer links with the countries of continental Europe over the period since it had joined the EU, its share of trade with the United Kingdom had contracted dramatically. That trend was likely to continue in the future, thereby alleviating some of the concerns about the linkage between the Irish pound and the pound sterling raised for the current discussion. Meanwhile, Ireland should continue to pursue policies aimed at fiscal consolidation and structural reform in order to enhance the economy's flexibility and its ability to adapt to external shocks.

Mr. Murphy thanked Directors for their constructive comments. Mrs. Wagenhoefer was correct to note the need for frank criticism in the context of Article IV consultations with members. Indeed, his authorities would welcome Directors comments on the need for fiscal consolidation, structural reforms to enhance employment, and privatization.

The current debate in Ireland on fiscal policy, particularly the need for expenditure restraint, was very similar to the thrust of the current discussion, Mr. Murphy said. However, transforming that debate into action would not be easy. Many of the decisions that had been taken over recent years to expand public expenditures had been aimed at objectives that went well beyond the year in which those decisions were adopted.

The Acting Chairman made the following summing up:

Executive Directors concurred with the thrust of the staff appraisal. Directors welcomed the continued favorable performance of the Irish economy with robust growth, low rates of inflation, and a strengthening external position, which was due in large measure to the disciplined macroeconomic policy stance of recent years. Directors observed, however, that the authorities faced a number of serious challenges, in particular to reduce the heavy public debt burden, enhance the credibility of exchange rate policy, and reduce unemployment from high levels. Meeting these challenges will require continued adherence to sound macroeconomic policies and more vigorous implementation of structural reforms.

Directors commended the authorities for containing the fiscal deficit and reducing the high public sector debt/GNP ratio. However, they regretted that the opportunity afforded by a buoyant economy to accelerate the reduction in the debt burden had not been used to full advantage, particularly in the 1995 budget. Directors emphasized the importance of firm expenditure restraint to allow the authorities to achieve both the goal of reducing the deficit and facilitating further tax reform. They, therefore, welcomed the introduction of medium-term ceilings on expenditure growth. The authorities' recent initiatives to curtail hiring and identify expenditure savings should add credibility to these commitments, which would need to be sustained--and, in the view of several speakers, should be strengthened--in the formulation of the 1996 budget and beyond.

Directors welcomed Ireland's commitment to maintain low rates of inflation and endorsed the tightening of monetary policy. They observed that the Irish economy's exposure to economic and financial developments in the United Kingdom posed an awkward dilemma for exchange rate and monetary policy, particularly at a time of sterling weakness. Most Directors considered that the credibility of the authorities' stated objective of early entry in the European Monetary Union (EMU) would be enhanced if they gave greater weight over time to minimizing the divergence of the Irish pound from its central parity in the exchange rate mechanism of the EMS. In this context, they noted that Ireland's favorable competitive position and its large external surplus suggested that there was some scope for the Irish pound to appreciate against the pound sterling, and this would help keep inflation rates under control. Taking account also of the pace of activity and credit expansion, further monetary tightening appeared justified. Some Directors considered, however, that the tightening to date was sufficient.

Directors saw Ireland's stubbornly high rate of unemployment as largely a structural problem, and they urged a more vigorous approach to remove the obstacles to job creation; in particular, they suggested that more could be done to reduce the high replacement ratios and tax wedges that deter job search and creation, to narrow the bias in the tax code against the labor-intensive indigenous services sector, to encourage more flexible work practices, and to allow greater relative wage flexibility than occurs within the current wage-determination framework.

Directors also noted that the combination of high unemployment and a large external surplus suggested a need for structural reforms to improve the climate for domestic private investment. These measures should focus on public enterprise reforms, including a more active privatization policy and strengthened competition policy.

Directors encouraged the authorities to improve the timeliness of external trade data and the frequency of the compilation of consumer price data and national income accounts.

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

4. GHANA - 1995 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with Ghana and Ghana's request for arrangements under the enhanced structural adjustment facility (EBS/95/76, 5/9/95; and Sup. 1, 6/27/95). They also had before them a policy framework paper for the period 1995-97 (EBD/95/63, 5/9/95), background information on output and investment performance (SM/95/112, 5/22/95), and a statistical annex (SM/95/114, 5/23/95).

The staff representative from the African Department noted that the pledges made by donors at the Consultative Group meeting on June 13-14, 1995 were expected to cover the external financing gap over the period of the proposed enhanced structural adjustment arrangement.

Mr. Mirakhor made the following statement:

My Ghanaian authorities would like to express their appreciation to the Fund management and the staff for having expeditiously brought Ghana's request for an enhanced structural adjustment before the Executive Board for consideration, and for the clarity and balance of the staff's analysis and policy recommendations. They are in broad agreement with the staff's assessment of Ghana's present economic situation and the challenges that lie ahead. My authorities would also like to take this opportunity to thank the staff for the excellent background paper on output and investment performance in Ghana.

Ghana's economic performance in 1993-94 presents a mixed picture of favorable elements and emerging strains. On the one hand, strenuous policy efforts, combined with receipts from the sale of public assets, enabled the authorities to achieve a significant improvement in public finances and the external position. Specifically, the budgetary position swung from a large deficit to a moderate surplus while the significant devaluation of the cedi and favorable export performance led to a sharp reduction in the external current account deficit and a buildup of external reserves, notwithstanding large shortfalls in external assistance. However, these accomplishments were overshadowed by other less favorable developments. Despite the improvement in public finances and a step-up in the open market operations of the Bank of Ghana, the conduct of monetary policy was undermined by the acute financial difficulties encountered by the national oil company. As a consequence, broad money growth accelerated sharply, leading to an intensification of inflationary pressures; private investment was restrained; and economic growth slowed.

Against the background of these developments, the authorities' current strategy is to reinvigorate their efforts to restore macroeconomic stability, broaden and deepen the process of structural reform, and strengthen the foundations for renewed growth and poverty alleviation. In support of these objectives, the authorities have formulated a medium-term program of macroeconomic and structural policies that are to be implemented during the period 1995-97, with financial assistance from the Fund. The modest level of access being requested reflects the authorities' hope that recourse to exceptional financing will not be construed as a retrogressive step. They wish to underscore that their commitment to policy reform and adjustment remains unwavering. However, it is their view that a formal financial arrangement with the Fund would serve to boost donor and creditor confidence and help catalyze the concessional assistance and direct investment that is needed to raise domestic investment and growth. More important, such an arrangement should preclude the highly destabilizing effects of recurrent, large shortfalls in committed external assistance from other multilateral and bilateral sources that have severely complicated the task of economic and financial management over the past three years.

The authorities' program for the 1995-97 period is well described in the staff papers and the accompanying policy framework paper. It embodies a comprehensive and well-sequenced set of policies in the macroeconomic and structural areas, and warrants the full support of the international community. I would like to focus on some of the program's key features.

With respect to macroeconomic stabilization, a major objective is to strengthen public finances. The achievement of this objective will require strong fiscal policy adjustment and continuing budgetary surpluses. Among the many elements on the revenue and expenditure side that call for steadfast implementation, the most important are the value-added tax and wage restraint. As described in the staff supplement, the introduction of the value-added tax ran into fierce opposition when it led to an exaggerated price effect. This, in turn, provoked strident demands for compensating wage increases. In the interest of social harmony, and being mindful of the need to garner the political support of all social partners for the adjustment program, the authorities reacted on both fronts: they rescinded the value-added tax and reverted to the old sales tax; and they conceded a somewhat larger increase in wages than had been previously envisaged. As the staff supplement and the letter from the Minister of Finance attest, the authorities have taken compensating measures that fully protect the integrity of the fiscal plan. It is their expectation that the value-added tax, or an equivalent type of tax, will be reintroduced at a suitable future date. On the issue of wages, the authorities intend to stand firm against future wage demands that would risk giving impetus to a cycle of further inflationary pressures and undermine the economy's competitiveness.

Fiscal restraint will be complemented by a tight monetary policy to support the authorities' inflation and external sector objectives. While this may well entail a prolonged period of high real interest rates, the authorities are determined to first firmly establish a low level of inflation. This anti-inflation strategy has two elements: in the first phase, monetary restraint will be accompanied by an exchange rate policy that is conducted in a manner consistent with the need for protecting Ghana's external competitiveness and foreign exchange reserve position. Once sufficient progress has been made toward reducing inflation, the authorities will give consideration to moving to a system in which the exchange rate can play a role in anchoring prices. This would provide a clear and testable signal of the authorities' commitment to maintaining a strong anti-inflationary policy stance. The two-step strategy being proposed by the authorities would appear to be the best course of action in the present circumstances of liquidity overhang and high inflation.

The authorities recognize that substantial structural reforms are needed to ensure the sustainability of the adjustment effort, and that accelerated and decisive progress in this area can be a major factor in fostering credibility in the program and attracting much needed inflows of foreign private investment. Accordingly, high priority is to be given to strengthening the environment for private sector initiative, including removing state involvement in all areas of activity that can be handled more efficiently by the private sector. Indeed, the structural actions that are to be undertaken represent one of the strongest elements of the program. Specific actions in this regard include the acceleration and expansion of the divestiture program and a bold deregulation of the petroleum and cocoa sectors. In regard to the former, an excellent start was made when, in a landmark decision, the sale of nearly one half of the Government's share in the largest state enterprise, the Ashanti Goldfields, was successfully concluded in 1994. The Government intends to broaden and accelerate the pace of this program by divesting three banks and 48 small or medium enterprises, and by offering for sale Ghana Telecom, the state insurance company, the state housing corporation, and Mim Timber.

The recent financial difficulties of the national oil company have highlighted the need for determined action to raise efficiency in this sector, and the authorities have committed themselves to a comprehensive liberalization of this sector including: terminating the national oil company's access to new credits at the Bank of Ghana; restricting its operations to hydrocarbons and energy-related activities while selling its assets to pay off all outstanding debts, including those to the Bank of Ghana; allowing the full decontrol of petroleum prices; and paving the way for the eventual privatization of the national oil company, the Tema Oil refinery, and the state-owned oil marketing company (GOIL). Finally, while good progress has been made in deregulating cocoa marketing, by allowing private traders to compete directly with the Cocoa Board, room for further improvement remains. To exploit these efficiency gains, the authorities intend to remove the Cocoa Board's monopoly following the completion of a review of the appropriate modalities of deregulation.

With regard to the external sector, Ghana's balance of payments position can be expected to move toward the attainment of viability over the medium term, accompanied by a moderate reduction in the external debt service burden. The staff's balance of payments projections and sensitivity tests suggest that while there are some risks stemming from the commodity concentration of Ghana's exports, the balance of payments is generally robust and is not unduly sensitive to downside risks. Clearly, however, such a favorable outcome is predicated on the full and complete implementation of the Government's stabilization and reform program, on the one hand, and the continued, sustained support of the international community, on the other. The modest financing gaps envisaged for 1996-97 were filled in the context of the Consultative Group meeting held earlier this month, thereby sending a strong signal of donors' endorsement of, and confidence in, the authorities' ambitious adjustment program.

Mr. Evans noted that Ghana had been undergoing a lengthy period of adjustment over the past decade. While a great deal of progress had been made during that time, Ghana remained a very poor country with macroeconomic imbalances, and much remained to be done. At the present stage, it would be of paramount importance for the authorities to regain credibility and reaffirm and demonstrate their commitment to poverty alleviation and stabilization.

As the need to achieve macroeconomic stability and a prudent fiscal stance was at the heart of Ghana's problems, the emphasis placed by the enhanced structural adjustment arrangement on those issues was welcome, Mr. Evans said. The excessive financial drain placed on the budget by the national petroleum corporation over the past year clearly showed that the authorities had allowed that corporation to have access to central bank credit for too long, with weak monitoring efforts, Mr. Evans stated. Therefore, the ceiling that had been placed on central bank credit to the national petroleum corporation under the program and the plans for restructuring the company were welcome.

With respect to the fiscal policy stance, he agreed with the staff that it was worrying to note the unfortunate political difficulties that had forced the Government to rescind the value-added tax, Mr. Evans stated. He wondered whether the staff could comment on the prospects for an eventual reintroduction of the value-added tax in some form. Experience in many countries showed that it was important to carefully devise a thorough implementation strategy for a value-added tax prior to its introduction. He wondered whether any lessons could be drawn from Ghana's experience that could benefit not only Ghana, but also other countries.

It was reassuring to note the speed with which the new fiscal package dealing with the measures needed to make up for the policy change regarding the value-added tax and the higher than programmed public sector wage increase had been put together, Mr. Evans commented. He agreed with the staff that the current fiscal stance was appropriate, given the current political situation in Ghana. Nevertheless, the recent experience of Ghana pointed to the vulnerability of its fiscal program, in particular with respect to public sector wage increases. It would be important to carefully monitor developments with respect to fiscal policy over the coming year, as that was an area where pressures were liable to increase in the runup to the elections.

In that context, a more rapid civil service reform, including retrenchment, would help to ease pressures on the wage bill, Mr. Evans considered. It was to be hoped that the authorities would move forward decisively in their efforts to reform the civil service, as indicated in the policy framework paper.

He agreed with the staff that privatization receipts--which were one-off sources of revenue--should be used not to make up for revenue shortfalls, but to bring Ghana's domestic and external debt down to more manageable levels, Mr. Evans stated.

With respect to monetary and exchange rate policy, the authorities' commitment to bring inflation rates firmly under control was a necessary precondition for the achievement of higher rates of growth, Mr. Evans continued. It was surprising to note from the staff paper that the authorities are considering a move to a fixed exchange rate system. Indeed, the move from a fixed exchange rate to a market-determined exchange rate had been a central plank of Ghana's successful adjustment program in the 1980s. The staff had correctly noted that the authorities must ensure that domestic policies were sufficiently strong to avoid an overvaluation of the new exchange rate before fixing it. Nevertheless, there was reason to be skeptical about such a move, given the timetable for its consideration, which might take place next year. In the circumstances, if such a move seemed to be in prospect, it should be a main topic of discussion at the time of the midterm review of the program. He wondered whether some of the planned build-up in foreign exchange reserves might be connected with the implicit belief that a move to a fixed exchange rate might be made during the course of the proposed enhanced structural adjustment arrangement.

The design of the proposed program was appropriate, as it would enhance the prospects for private sector development and donor confidence in the authorities' intentions, Mr. Evans went on. The modest level of access envisaged under the program was also appropriate, given the financing needs of Ghana, and the automatic adjustors included in the program were welcome.

As in the case of many other countries, economic development in Ghana would depend on the establishment a vigorous private sector, Mr. Evans said. In the past, the development of the private sector had been hindered by the lack of consistent progress toward macroeconomic stabilization and a somewhat ambivalent attitude on the part of the Government, or certain parts of the Government. Against that background, it was pleasing to note that the Government had begun to establish new channels for communication with private sector agents.

The privatization program was well under way, and progress in that area was being accelerated, Mr. Evans noted. The World Bank was playing a very helpful role in that respect. Nevertheless, it would be important for the authorities to bear in mind that consistency of purpose and execution in all things connected with the private sector was essential.

Mr. Mirakhor said that privatization proceeds had not been used to cover shortfalls in domestic revenues; they had been used to offset a massive shortfall in long-term external assistance.

At the present stage, the authorities did not intend to move to a fixed exchange rate regime, Mr. Mirakhor stated. Nevertheless, as high rates of inflation over the past two or three years had eroded private savings and generated social problems, the authorities planned to closely monitor the inflation performance over the first two years of the program. If the rate of inflation could not be brought under control within that time frame, the authorities would then consider adopting an exchange rate anchor.

Mr. Ryan made the following statement:

With its graduation from the ESAF arrangement a few years ago, the general perception had taken hold that Ghana was firmly embarked on a sustainable, market-oriented development track. Ghana has a reasonably strong reserve position, a four-month import cover, and continues to enjoy access to international capital markets. Growth has generally been strong over the past few years, moderating somewhat last year.

As the staff papers make clear, however, the momentum of Ghana's reform efforts has clearly stalled in recent years. Mr. Evans has highlighted some of these slippages. Stabilization efforts have been weakened, in particular, by overly generous public sector wage settlements, underperforming state enterprises, and monetary overruns. Fiscal accounts have been slow to recover from the massive public wage increases granted prior to the 1992 elections. Inflation has not recovered, rising steadily, and accelerating to about 34 percent last year. Base money grew by 78 percent in 1994, nearly ten times the programmed growth rate. The state oil company apparently accounted for much of the expansion of credit--highlighting the adverse impact on stabilization of inadequate structural reform.

In sum, Ghana's performance under the staff-monitored program has deteriorated, calling into question--and possibly putting at risk--stabilization gains that have been made as well as growth prospects. The comprehensive background paper on growth and output in Ghana makes clear the adverse impact on savings and investment behavior resulting from destabilizing increases in inflation and the still-heavy government interference in the economy. A viable external accounts would not be sustainable if such conditions were to persist. In view of these circumstances, the proposed ESAF-supported program appears timely and necessary. It will provide the framework that appears necessary to catalyze reform efforts and external flows. Ghana does not require debt rescheduling under the auspices of the Paris Club, and ESAF access is relatively modest. The primary void filled by the ESAF arrangement is the discipline it will apply to the adjustment and donor processes.

In our view, the timing of the program is advantageous. With elections scheduled to take place in 1996, the increased discipline of a Fund-supported program should help prevent a repeat of the 1992 wage hike and other forms of election-year spending largesse. That being said, the program has not gotten off to an auspicious start with the recent rescission of the value-added tax and the additional price hike. The carry-over of the 1994 monetary overhang and the imposition of the value-added tax proved a politically volatile combination. The resulting rescission of the value-added tax and increase in the wage bill are unfortunate. While the projected fiscal target is maintained by offsetting fiscal and spending measures, the quality of the adjustment is reduced. The signaling effect of the additional wage hike could make the containment of inflation more difficult. Efforts to broaden the tax base have been set back by the shelving of the value-added tax.

We still consider this to be a strong program. There appears to be a strong emphasis on jump-starting private sector activity in Ghana. This is critical. Private sector investment has fallen from 8.1 percent of GDP in 1991 to 4.4 percent in 1994. Not surprisingly, the rate of GDP growth slowed last year. The background paper diagnoses the range of factors inhibiting private investment. A key theme among its prescriptions is the general need for less government--less government spending, particularly on wages, and less government intervention in the economy. The program is designed to make headway in both areas. The privatization program is to be accelerated. Hard budget constraints will be imposed on remaining state firms. Deregulation of the oil and cocoa sectors are included among the structural benchmarks. Fiscal policies seek reductions in recurrent expenditure and target fiscal surpluses, excluding divestiture receipts, in 1996 and 1997.

The program is not perfect. For example, we wonder why the Government retains a 40 percent share in the commercial banks to be privatized. We would have preferred a schedule for phasing out the cocoa export tax. We are also disappointed at the rather uncertain prospects for concrete action on civil service downsizing.

While we would prefer to see more done, more rapidly, in various areas, we still find this to be a credible package.

Credibility depends crucially on implementation, of course, not just on commitments. This may be doubly important in the Ghanaian case, not only because of the need to overcome recent performance slippages, but also because of the apparent desire of authorities to consider establishing at a future date a fixed rate nominal anchor, once inflation is brought under control and demand management is perceived as credibly tight.

Such a two-step approach to stabilization raises a number of questions. Bearing in mind Mr. Mirakhor's description of the authorities' intent, we still are somewhat skeptical, and I believe that I share Mr. Evans's view on this. First, can the basic preconditions be met? Among other things, achieving anti-inflationary fiscal and monetary policies will require overcoming special interest pressures that have resulted in enterprise bail-outs, large wage settlements, and other expansionary outcomes. A follow-on concern is whether a fixed rate regime is appropriate for a country dependent on a narrow range of commodity-based exports and vulnerable to terms of trade fluctuations--particularly one in which internal adjustment is frustrated by rigidities in the labor market. Given these concerns--and I believe that Mr. Mirakhor has partially, or perhaps fully, answered this question--I wonder what sort of time frame the authorities are contemplating for a possible movement to such a regime. I would also be interested in the staff's view on this. I did not detect in the report great enthusiasm from the staff for an exchange rate anchor, and wonder whether the staff could be more explicit on this point and on the advice it is providing the authorities.

Finally, one has the impression that many of the policy shortfalls of recent years--such as, excessive wage settlements, the limited government retrenchment, and the slow progress on privatization--are due to the authorities' sensitivity to trade union pressures. I wonder whether either the staff or Mr. Mirakhor could comment on whether union pressures on wages, for example, are the natural response to the Government's failure to control inflation, or rather are the result of particular structural problems. To the extent that the latter is the case, I wonder what is being done to address that particular area.

Mrs. Cheong made the following statement:

I would begin by expressing my appreciation for the very useful background paper, which facilitated an understanding of Ghana's economic prospects from a longer-term perspective. The paper--with further updates from Mr. Mirakhor's statement--confirms the simple maxim that macroeconomic stabilization cannot be sustained when there are set-backs to the structural, institutional, and growth-enhancing strategies. The authorities are now more committed to putting the economy back on track through a resumption of stabilization measures, to be sustained by measures to remove structural rigidities, induce private domestic savings and investment, and instill private sector confidence. Another ESAF arrangement would help Ghana follow up on a generally good record of adhering to Fund advice, while the provision of financial assistance and policy guidance by the Fund would ensure that the new medium-term program was sustained. I, therefore, support the proposed decision, and would like to make some brief comments.

In light of recent policy slippages in the fiscal area, Ghana must demonstrate a commitment to fiscal deficit reduction, through strengthened measures to reduce expenditure, in particular, by exercising strict control on personnel outlays, despite strong pressures for wage increases. Failure to control this pressure alone would undermine the Government's efforts to rebuild its credibility with regard to macroeconomic management, and would further erode private sector confidence. In light of previous experiences, the ability to address this issue, especially in view of the presidential and parliamentary elections in 1996, would give a clear indication of policymakers' commitment to reforms. On the revenue side, revenue would be strengthened by a tax reform through an expansion of the revenue base with a lower rate, rather than by a higher rate with a narrower base. In this light, I note Mr. Mirakhor's explanation of the need to meet demands from various quarters, and thus a gradual implementation of new taxes may be more appropriate.

In the monetary sector, fiscal discipline, further tightening of monetary policy, and the removal of administered credit would address the inflation problem. I agree with the staff that the success of stabilization policies rests mainly on sound and effective financial policies. The present system of basing monetary policy on the changes in the monetary base would serve the economy well if supported by the appropriate monetary instruments and an efficient financial sector. The latter is also important to facilitate higher domestic savings. Following the reform and strengthening of banks' capital base, promotion of financial intermediation would be expedited through greater competition arising from privatization of commercial banks and issuance of new licenses. In this regard, care should be exercised to maintain, at all times, strict prudential rules to ensure the credibility of the banking system. At times, during the opening up of the financial sector, there could be political pressures to relax some of these rules. This must be strongly resisted.

With regard to the external sector, the current account is likely to remain fragile. The export base is still narrow, with a large share of export earnings dependent on weather conditions. More comprehensive policies on the financial and institutional fronts are required to support the export-bias strategies being adopted. Specifically, to promote exports, restrictive export regulations--including export tax and state-owned monopolies in exports--should be addressed. However, I recognize that export taxes are an important revenue component and their removal must be gradual, until other substitute revenue sources are imposed.

We note that the economy is still pursuing an import substitution strategy, as evidenced by an introduction of 10 percent import duties affecting 60 percent of import value. This will affect the real effective rate of protection and, as the coverage appears to be quite broad, will also run counter to the present policy of removing the anti-export bias.

As stated earlier, stabilization policies alone will not guarantee growth in Ghana. To improve GDP performance, improving efficiency in resource allocation must be accompanied by measures to encourage investment to expand the domestic production capacity. This requires not only higher domestic savings, but also the creation of a conducive investment climate for both domestic and foreign investors. To this end, I concur with the staff that it is essential for the authorities to send an unequivocal signal, that it will faithfully conduct measures to enhance the private sector's role in economic activities. Privatization should proceed, while liberalization measures would need to be complemented with appropriate institutional framework, including legislation governing property rights, particularly those relating to land ownership, export financing schemes, and smooth approval mechanisms for new investments. I should emphasize that all that is required of the Government is the creation of this "business friendly" environment. After that, the market mechanism should ensure that new investment would contribute to diversification of the production base, versus the current narrow one, which is based on only a few agricultural goods.

Mr. Dlamini made the following statement:

The Ghanaian experience is a good example of what we mean in saying that economic adjustment and reform is likely to be a long-term process especially in low-income countries. It will be recalled that Ghana launched its economic recovery program in 1983, and has kept at the business of reform since, winning approval as one of the few "model adjusters" in Africa. Nevertheless, the country still has a long way to go in establishing the basis for sustained growth and external viability. Perhaps, we should start thinking in terms of a longer horizon, say a five-year framework, as a step toward improving program design.

Ghana has made significant gains in attempting to stabilize its economy under successive programs. This was most noticeable on the inflation front, with a decline in the rate from 142 percent in 1983 to 10 percent by the end of 1991. The country also achieved high growth rates, leading to a rise in per capita income. However, as indicated in the staff report, the economy remains fragile. In retrospect, the reason seems to be that the reform strategy, while being strong on macroeconomic stabilization, was a little weak in strengthening the micro foundation of the economy. Perhaps, this is what prompted the authorities to stress in the policy framework paper that macroeconomic stabilization alone will not in itself guarantee accelerated growth in Ghana. This is an important lesson not only for Ghana, but for most countries undertaking economic reform.

The new economic program is a step in the right direction, and I fully support the authorities' request for an ESAF arrangement. It emphasizes all the necessary elements to strengthen the economy and make it more resilient; namely, strong incentives for the private sector; manpower development in both the public and private sectors; investment in basic infrastructure; improving agricultural productivity; diversifying the export base; and increasing expenditure on primary health care and basic education. Of course, we also recognize the authorities' continued emphasis on the pursuit of prudent fiscal and monetary policies. Such policies are indispensable to the fight against inflation and to maintaining a stable macroeconomic environment. Increased public sector savings will also enable the government to undertake the needed investment to raise productivity.

This is an ambitious program. It not only assumes a strong performance for exports, especially nontraditional exports, but also a strong pick-up in direct investment over the next three years. However, it establishes the proper objectives, and the prospects are encouraging. The Ghanaian authorities have a good track record regarding their commitment to economic reform. They need the full support of the international community.

Mr. Kpetigo made the following statement:

As reported by the staff in its comprehensive report, the Ghanaian authorities have thus far made commendable progress in their macroeconomic and structural reforms. During the period 1989-94, annual real GDP growth remained strong and was supported by a steady export-oriented production and growing nontraditional exports. Meanwhile, although the terms of trade deteriorated during most of the period, Ghana was able to adjust it external sector policy constantly, through a flexible exchange rate that helped take much advantage of the world markets. This strategy, in the face of worsened terms of trade, put less burden on implementation of both monetary and fiscal policies, namely, on the internal adjustment. However, performance on the inflation front was less encouraging and remains Ghana's most pressing concern today.

Despite the progress made so far, much remains to be done, and we urge the authorities not to relax their efforts. In this connection, we are pleased to note that the authorities have put in place a new program, for which they are requesting financial assistance from the Fund in the form of a three-year ESAF arrangement. As we agree with the staff's appraisal and endorse the view expressed by previous speakers, I will concentrate my comments on a few selected issues regarding the inflation front, the progress of structural reforms, and the external sector.

The 1995 program growth objective and prospects in the medium term hinge on two decisive conditions, the first of which would to deal with inflation and the second of which would seek to boost international reserves. As regards the anti-inflation strategy, we note that the program embodies two steps: first, in 1995, sharply reducing inflation, by using money supply as a nominal anchor for the financial system; and, in the second stage, using the exchange rate as an anchor to maintain the inflation at end-1995 level. Considering that the inflation rate is presently high in Ghana, as a reflection of the expansionary monetary policy implemented over the previous years, we wonder whether the corrective measures anticipated for the restructuring, and the better management of the national oil company with respect to its large domestic debt to the Bank of Ghana, will be enough to significantly improve the rate of inflation.

On structural reform, we commend the authorities for their determination to develop a far-reaching privatization program, which provides for leaving only a few state enterprises in the public domain. We agree with them that these state entities should be strengthened and placed on a profit-making basis. However, we would like to caution the authorities about some underlying risks that remain, in particular, with regard to putting these enterprises under a performance contract system. This strategy has been implemented in some other countries, and it resulted in a type of structural blockade that prevented any corrective attempts to switch to new reforms that were seen as necessary. Thus, it would appear that flexibility in this area is warranted.

Concerning external sector developments, we welcome the authorities' confidence in their ability to achieve the objectives of the program, based on the assumptions they have made on the medium-term prospects. The consideration of the baseline scenario presented in Table 11 of the staff report clearly suggests the prevalence of gold price developments in the medium-term outlook of the balance of payments. Although lower aid flows could undermine the international reserves position to some extent, the reduction in this sector, if any, compared with that presented in any of the other three scenarios, would not affect the global reserves position to a significant degree. This is a reflection of the economy's reduced dependence on external aid flows, provided that Ghana's traditional and nontraditional export prices sustainability is solid. This underscores the authorities confidence and their decision not to resort to debt rescheduling under the auspices of Paris Club. However, in any case, the shortfall in reserves points to a steady vulnerability of the economy, and this would be more worrisome if gold prices were to deteriorate. It is thus worth noting that the Ashanti Goldfields privatization was, fortunately, successfully concluded in 1994. We share the staff's view that the external position is promising, although risks do remain.

Ghana has thus far made tremendous progress, and we call on the donor community to continue to offer its financial assistance to support Ghana's adjustment program. With these remarks, I support the proposed decision and wish the Ghanaian authorities every success.

Mr. Kannan made the following statement:

When the stand-by arrangement with Mexico was approved on February 1, 1995, the challenges faced by the Mexican authorities were so large and so many that many of us were somewhat skeptical whether the various performance criteria would in fact be met. This chair is happy to have been proved wrong in this respect. The turn around in Mexico's economy and that too in such a short period is really remarkable. We congratulate the Mexican authorities and the people of Mexico on their extremely credible achievement. There are no doubt slippages in a few areas. But these pale into insignificance when viewed against the backdrop of excellent performance in so many other areas.

In order to consolidate on the gains, strong fiscal prudence and tight monetary policy stance must be continued in the immediate period. As we are in agreement with the staff recommendations, let me only briefly mention a few important points.

With reference to exchange rate, we commend the authorities for their commitment towards maintaining floating exchange rate regime and this must be continued.

We encourage the authorities to expedite the privatization process and in this respect we are happy to note the amendment of the Constitution.

It should be the endeavor of the authorities to promote a viable banking system and in this context vigilance will be necessary on the quality of bank's loan portfolios, if the volume of nonperforming loans is to be contained.

We are happy to note that the authorities have taken important steps to expand the scope and improve the timeliness of economic data provided to the Fund.

With the restoration of confidence and policies firmly on track, we must allow some time for these policies to fructify and produce sustainable results. As the commitment of the authorities is clearly evident, we fully recommend the necessary waivers and endorse the decisions as proposed by the staff.

We wish the authorities success in their endeavors.

The staff representative from the African Department considered that, while the authorities probably would not move quickly to reintroduce the value-added tax, they had been very impressed with the increased revenues the tax had generated. Indeed, revenues had doubled during the period in which the value-added tax had been in place. Therefore, the authorities wanted to introduce a tax that would serve the functions of a value-added tax, but probably under a different name, as soon as possible.

As to the lessons that could be drawn from the Ghanaian experience, the staff representative said, it was important to educate the public about value-added taxes prior to their implementation; such taxes should not be introduced during periods of high inflation; and the best way to combat tax evasion would be to lower other tax rates in order to make the value-added tax more palatable to the public.

Mr. Evans commented that, because the value-added tax had resulted in a doubling of revenues, a reintroduction of the same tax would almost certainly lead to increased political pressures. In that respect, the most important lesson to be drawn from the Ghanaian experience was the importance of carefully preparing the way for the introduction of value-added taxes.

Mr. Mirakhor stated that Mr. Evans was correct to point out the need to carefully prepare the ground for the introduction of value-added taxes. In the case of Ghana, the authorities had not sufficiently educated the public about the purpose of the tax and the way in which it was to be implemented. Following the introduction of the tax, the prices of almost all goods had been raised by 17.5 percent, regardless of whether or not they were subject to the tax. Therefore, the price effect of the tax had been greatly exaggerated. In the light of that experience, the Ghanaian authorities were currently assessing their past experience in order to draw lessons for the future.

While the authorities would almost certainly reintroduce the value-added tax in some form, it would probably be given a different name--particularly if the reintroduction was to take place quickly, Mr. Mirakhor considered. In any event, it would be very important for the authorities to ensure that the public was well educated about the tax and the ways in which it would be applied prior to its reintroduction.

The staff representative from the African Department said that Ghana's flexible exchange rate regime had served the country well under the economic recovery program. However, it should be noted that inflation rates had not been brought under control. While the rate of inflation had started from a high of 140 percent when the economic recovery program was launched in 1983, it had never been brought to levels below 30 percent for more than a few months at a time.

The staff report was not intended to indicate that the authorities of Ghana should move to a fixed exchange rate regime, the staff representative noted. Rather, the staff had suggested that the authorities consider the adoption of a fixed exchange rate among the options that could be used to combat inflation. While Ghana was not likely to adopt a fixed exchange rate regime during the period of the program supported by the ESAF, the possibility of such a move should not be discounted.

The improvement in the reserve position, to 4.1 months of imports, was not intended to facilitate a move to a fixed exchange rate regime, the staff representative commented. Several factors were driving the reserve target. First, at some time in the future, the authorities hoped to move to full currency convertibility in order to remove capital controls; the higher stock of reserves would help to facilitate such a move. Second, Ghana's exports were highly concentrated, with three commodities accounting for 85 percent of export earnings; it was important to maintain a strong reserve position, as the international market conditions for those commodities were volatile. Finally, about 40 percent of Ghana's reserves reflected either short-term external borrowing by the Coca Board--which could be easily reversed through domestic borrowing--or proceeds from the divesture program, which could be used either for debt reduction purposes or for investment in long-term assets. Under the program, divestiture proceeds were not to be used for balance of payments financing.

Although the staff agreed with Mrs. Cheong that the current tax on cocoa exports provided a significant disincentive for production, the staff and the authorities had not yet been able to identify the means to fill the gap in revenues that would be created by the removal of that tax, the staff representative stated. The staff was making every effort to find a substitute form of taxation, and it would welcome any suggestions Directors might wish to put forward in that regard.

The Government had sold a large portion of its share in the commercial banks, as a key step in the privatization process, the staff representative noted. Further government shares in those banks would likely be sold in the future. A similar approach had been taken in the divesture of the Ashanti Goldfields.

The problem with respect to wages in Ghana had intensified recently, owing to the increase in inflationary pressures, the staff representative commented. The wage problem was also being fueled to some extent by the labor movement, which was trying to capitalize on the recent increase in inflation rates and the current vulnerability of the Government in the runup to the coming elections. In the period proceeding the 1992 election, the labor movement had succeeded in its efforts to attain very large increases in wages, and it was probably hoping to duplicate that experience.

The measures undertaken with respect to the national oil company seemed to be working well, the staff representative from the African Department considered. The company's access to central bank credit had been cut off, and it had not undertaken any new borrowing. As a result, broad money had contracted by 12 percent during the first three months of 1995. Indeed, if the national oil company had not undertaken any borrowing from the central bank in 1994, the growth of broad money would have been 3 percent, as opposed to 46 percent.

Mrs. Cheong noted that, like Ghana, many of the countries in her constituency had made a great deal of revenues through export taxes in the past. The experiences of those countries showed that it was very difficult to find tax substitutes that did not create disincentives to production. Nevertheless, as the private sectors in those countries had expanded, it had become possible to substitute for export taxes over time by raising taxes on corporations.

Mr. Mirakhor said that, while the private sectors in the countries in Mrs. Cheong's constituency had been major players in the economy for some time, the private sector in Ghana had not yet become a moving force for growth in the economy. Indeed, that was an important factor in the difficulties involved in trying to find ways to replace export taxes in Ghana. Over the past five or six years, the Fund staff had been stressing the importance of supporting private sector operations in Ghana as a means of spurring growth. The authorities expected that, as the private sector became an active force for growth in the economy, it would become possible to remove the taxes on exports.

The staff representative from the Word Bank commented that, over the past two years, there had been a seachange in the Government's attitude toward private sector development. Following the sale of 40 percent of the Government's share in the Ashanti Goldfields in 1994, the authorities had divested 18 companies. The divesture program had been greeted by the private sector as a great opportunity. The re-enactment of Ghana's liberal investment act had opened the door for both foreign and domestic investment. Moreover, the Government had organized a "roundtable" on private sector development, which met frequently to allow for an exchange of views between the authorities and entrepreneurs on issues related to the development of the private sector.

With the support of a World Bank Financial Sector Adjustment Credit, the authorities were preparing three large commercial banks for divesture, the staff representative noted. Independent consultants were currently preparing those financial institutions for privatization, and it was expected that the Social Security Bank would be ready for public offering in September or October 1995. The National Investment Bank was expected to be offered for sale by December 1995, and the largest commercial bank in Ghana, the Ghana Commercial Bank, was expected to be privatized by March 1996.

Under a recently approved Private Sector Adjustment Credit from the World Bank, 48 of the 110 small and medium-sized state-owned enterprises in Ghana would be either privatized or liquidated over the next 18 months, the staff representative stated. In addition, three major state-owned enterprises, including Ghana Telecommunications, would be privatized.

The above-mentioned measures were intended to lead the way toward the achievement of a very open and liberal environment for private sector development, the staff representative from the World Bank said.

Mr. Rainford asked whether the movement in Ghana toward a 10 percent import tax could be seen as a movement toward greater import substitution. He also wondered how that level of import taxation compared with the level of import taxation in similar countries. Moreover, he wondered whether moves toward import substitution should be weighed against the need for the external sector to contribute to the revenue effort.

The staff representative from the African Department noted that the import duty of 10 percent applied to goods--a large portion of which were intermediate goods--that had previously been zero-rated or exempted from taxation. While the World Bank staff was currently calculating effective protection rates in Ghana, preliminary indications showed that the tax measures implemented under the program had actually helped to reduce the effective rate of protection while simultaneously raising revenues.

Mr. Andersen made the following statement:

As I broadly agree with the staff's analysis and recommendations, and can associate myself with many of the comments made by previous speakers, I will limit myself to two observations at this stage.

First, I would like to emphasize the urgency of proceeding expeditiously with the deregulation of the cocoa and petroleum sectors. The restructuring of the national oil company is welcome, as the continued existence of the national oil company in the present form, which has politicized the decisions on petroleum prices, would be a major threat to fiscal stability. However, it is not clear why it is not possible to liberalize prices earlier than June 1996. Is there a concern about adequate competition, or perhaps a fear of political unrest, that causes the authorities to proceed gradually? I would appreciate some comments.

Second, the authorities' emphasis on creating a favorable climate for investment is most welcome. It is essential in terms of attracting foreign direct investment. Nevertheless, I find it somewhat puzzling to see that the general strategy, or at least the expectations, seems to be based on import substitution, rather than on export promotion. Actually, exports are assumed to grow at about the same pace as output. In a country that follows an outward-oriented strategy, one would expect exports to expand considerably faster than output. Of course, I realize that many countries that have successfully followed a strategy of export-oriented policies have started out with import substitution. But I think it is also true that those that have failed to make the transition from import substitution to export promotion have experienced serious setbacks. Hence, I wonder whether the contemporary import substitution tendency is a phase of a long-term strategy, or whether reflects a more fundamental tendency to focus on the domestic market. I would appreciate the staff's comments on this issue.

With these comments, I support the proposed decisions.

Mr. Oya made the following statement:

As I am in broad agreement with the staff's views and recommendations, I will limit myself to a comment on policy issues.

It is regrettable that the authorities have rescinded the value-added tax because of an outbreak of civil disturbance in mid-May 1995. The introduction of a VAT is indispensable, not only for short-term revenue reasons but also from the long- term perspective, especially for broadening the tax base and building a tax structure that would reduce the distortions that hinder economic activities. I expect the authorities to continue to make their best effort to create a social and economic environment conducive to the introduction of a VAT.

It is also quite important to reduce wage expenditure, which is currently absorbing more than 5 percent of GDP, in order to reduce the government deficit. It is disappointing that the authorities have announced a 30 percent increase in the civil service wage. I would urge that the authorities implement the civil service restructuring program in order to contain the increase in wage expenditure.

With respect to monetary policy, the inflation caused by the acute financial difficulties of the GNPC must be brought under control in order to achieve enhanced growth. I would therefore expect the authorities to implement a strong anti-inflation policy based on the two-step strategy.

Further progress in the privatization and deregulation of the banking sector is needed in order to increase its efficiency. In this connection, I commend the authorities' decision to sell 60 percent of its share in three commercial banks.

Finally, on structural reform, it is commendable that the authorities have shown a firm intention to reform the oil industry by taking some deregulation measures including curtailment of the GNPC's operation. Also, the restructuring of the cocoa industry is well under way. I would urge the authorities to make further progress in this area during the program period. I would also suggest that the authorities continue to diversify export industries in order to absorb external shocks such as a fall in cocoa prices or bad weather.

Mr. Ramdas made the following statement:

We support the proposed decision and would like to offer the following comments.

We are in broad agreement with the staff and the authorities' monetary policy stance to lower inflation. In the areas of adjustment and reform, some additional qualifications may be noted.

The restructuring of the tax system is both timely and appropriate for the Government. Regarding export taxes, at the moment, these appear exceptionally high.

Plans for restructuring the public service and improving its efficiency should lead to at least a balanced government budget by 1996. Higher revenues and noninterest expenditure cuts show a projected overall surplus close to 1.2 percent of GDP for 1995-97. Ghana's debt-service ratios have stabilized and are projected to decrease further in the medium term from higher exports. We would support the use of excess divestiture receipts over projections for commercial debt reduction. This should reduce the level of taxation required to balance the budget.

In the petroleum sector, the Government's watch over profit margins, through an adjustable ceiling, is a precaution that may prove to be unnecessary. With five distribution companies in the private sector, competitive pricing should prevail. The setting of ex-refinery prices no higher than import prices by Tema Oil Refinery is a step in this direction.

The Government's initiatives to set a framework for dialogue with the private sector augurs well. The new Investment Act should pilot new companies into the public utility sector, and the Statutory Corporations Act should facilitate corporatizing public enterprises. Individual unincorporated farmers should also have access to comparable industry support services to facilitate growth.

Finally, we thank the staff for the ample information provided for this discussion, and we wish the authorities every success in their new program.

Mr. He made the following statement:

The Ghanaian authorities experienced considerable challenges in the past year, in particular, the financial difficulties encountered by the national oil company and the sharp shortfall in long-term concessional aid. Nevertheless, the authorities deserve commendation for their firm commitment and efforts to restore macroeconomic stability, as clearly stated in Mr. Mirakhor's statement. Despite the shortfall in external concessional financing, Ghana managed to make significant improvement in public finances and the external position, thanks to vigorous policy efforts, the proceeds from the sales of public assets, the terms of trade improvement, and a strong export performance.

As my concerns have been addressed by the previous speakers, and I am in broad agreement with the staff analysis and policy recommendations, I will only emphasize some important challenges faced by the authorities.

A major source of disruption was from the public sector, in particular, the national oil company's financial difficulties, which caused the acceleration of broad money growth, an intensification of inflationary pressures, and revenue losses. Therefore, during the program period, priority should be given to minimizing distortions and inefficiency in the public sector. The initiatives to disengage the Government from commercial activities, if implemented carefully, will constitute a giant step in this direction. However, selling large- and medium-sized state-owned enterprises is only a first step. It is more important, and more difficult, to create and maintain a competitive environment, in order to achieve the desired results. In this connection, the formation of a Private Sector Roundtable and the introduction of the new Investment Act are welcome steps. In addition, in view of the young age of the private sector, a thorough review of policies aimed at removing potential disincentives and impediments to competition, especially in the agricultural, service, and small business sectors, may prove particularly rewarding.

Another major challenge is the relatively inadequate domestic savings and investment. The authorities' ambitious objective of accelerating growth to 5.5 percent by 1997, and 6 percent by the end of the decade, is necessary to lift population out of poverty. But it will require great efforts to generate more saving and investment. While proceeds from the sale of state assets have contributed to the improvement of public finances, such sources are not sustainable. In addition to liberalization and divestiture efforts, the long-term solution lies in maintaining credible fiscal and monetary policies conducive to the growth of savings and investment, including foreign investment. At this critical stage of their endeavors, strong external support will play an important role in covering Ghana's financing requirements during the program period.

Last, but not least, is the daunting task of maintaining stability. I agree with the staff that the strategy of the Government's program is realistic and well designed. However, recent developments in Ghana have underscored the importance of broad-based stability for the successful implementation of the program. Sustained stability--including political consensus and strong popular support for both reform and a stable financial environment--will be essential to achieving the objective. And such support, in the long run, can only be maintained with credible policies. In this regard, while I welcome the authorities' plan to curtail the growth of money, I join the staff in urging the authorities to guard against the potential erosion of policy strength during the upcoming election. Moreover, they are encouraged to conduct more extensive public education on the reform program, to closely monitor its implementation, and to be prepared to take timely corrective actions as warranted by such unexpected factors as unfavorable weather, changes in the terms of trade, or shortfalls in external financing.

I support the proposed decision and wish the authorities success.

Mr. Al-Huseini made the following statement:

I commend the Ghanian authorities for their efforts to strengthen their fiscal and external balances during 1993-94. The government budget recorded a surplus of 2.2 percent of GDP in 1994, and Ghana's international reserve position improved. However, inflationary pressures intensified.

I welcome the objectives of the medium-term program to attain sustainable annual real growth rates of about 6 percent while limiting inflation to 5 percent. Achieving these ambitious objectives, however, will depend to a large extent on diversifying production and exports, while maintaining tight financial policies. The experience of Ghana illustrates that Ghana's potential for reaching accelerated growth path was constrained by the limitations of the private sector response. In this regard, I agree with the staff that the removal of state involvement in activities that can be better conducted by the private sector will be critical to achieving the objectives of raising per capita GDP. Moreover, efforts to strengthen the legal and regulatory environment are needed. In this connection, I welcome the Government's recognition that continuing structural reform will be necessary to improve the incentives for the private sector and to attract much-needed inflows of foreign private investment. Indeed, the acceleration and expansion of the divestiture program as well as a bold deregulation of the petroleum and cocoa sectors are appropriate.

Achieving the program targets also requires further strengthening of public finances. Broadening the tax base and a vigilant wage restraint policy are the most important elements in this area. In this regard, it is encouraging to learn that the authorities are expecting that a value-added tax or an equivalent type tax will be reintroduced at a suitable future date, and that they will stand firm against future wage demands. Indeed, both steps are crucial to reduce the inflationary pressures and strengthen the economy's competitiveness.

The achievement of the authorities' inflation and external sector objectives will also require a tight monetary policy. In this connection, the two-step strategy proposed by the authorities would appear to be appropriate.

With these remarks, I support the proposed decision and wish the authorities every success in their reform efforts.

Mr. Gaspard made the following statement:

I join other speakers in congratulating the Irish authorities on a strong domestic and external performance that, since 1990, has overall surpassed that of the European Union on average. But challenges remain, particularly on the fiscal and unemployment fronts. I therefore also join the staff and other speakers in voicing concern about the pro-cyclical stance of the 1995 budget, especially that the underlying inflation rate has reached the Central Bank's upper limit of 3 percent, and notwithstanding the authorities' welcome commitment to contain non-interest current expenditure to 2 percent in real terms during 1996-97. I must add that the recently issued details concerning this commitment to future expenditure restraint will surely enhance the credibility of the authorities' stabilization policy.

I agree with the staff appraisal and find their call for containing the expansion in expenditure at a time of strong growth in output and credit demand to be justified. The need to give priority to fiscal tightening is made especially evident by Ireland's still very high debt ratio, despite recent notable improvements, and by the limited margin of manoeuver the authorities have in their exchange rate policy. The authorities are indeed committed to exchange rate stability through an announced objective of variation in the exchange rate of the Irish pound within a narrow band in the ERM. This would clearly shift some of the adjustment burden on both monetary and fiscal policies.

While the authorities have expressed concern about an eventual adverse effect of an increase in interest rates on domestic activity where a high proportion of credit is extended at variable rates, I believe the staff's call for further monetary tightening in view of the continued strong credit and overall domestic demand merits the authorities' consideration. On fiscal tightening, I would merely emphasize, in addition to my previous comments in this regard, that significant progress in public enterprise reform and privatization should greatly assist the fiscal consolidation efforts of the authorities in a more tangible and durable manner. Finally, the high openness of the Irish economy, together with the announced narrow band for the Irish pound, can only reinforce the argument for added emphasis on fiscal effort.

My last point concerns the issues of investment and unemployment. The recent strong growth in employment and the fall in unemployment since 1994 should not obscure the fact that the unemployment level in Ireland remains high and may be further exacerbated by the rising female participation in the labor force which, at a little less than 36 percent in 1994, still has a long way to rise to the European average of approximately 53 percent. Moreover, although the domestic and external economic performance in Ireland has been overall constantly superior to the average in the European Union over the last five years, the investment and unemployment performance has distinctly lagged behind for even a longer period of time. Ireland thus needs a sustained strong boost in its domestic investment that could simultaneously sustain the reduction in unemployment levels. The impediments appear to lie mainly in the structural domain and would call for an increase in labor market flexibility and the reform of the tax system and public enterprises in a way that would lower business costs to domestic enterprises. The positive performance of the Irish economy now affords the authorities a unique opportunity to stimulate domestic investment and employment without doing much prejudice to their stabilization objectives. This opportunity should be seized, especially in view of Ireland's favorable competitive position and its large external current surplus in particular, noting that the transfers from the European Union are expected to decline after 1999.

Mr. Rainford made the following statement:

The legacy of a decade of strong reform in Ghana since the early 1980s has not been well served by the slippages in the fiscal and monetary situation that occurred in 1992, especially as incomes remained very low even after the impressive macroeconomic progress of the 1980s. The authorities are to be commended, nevertheless, for quickly adopting staff-monitored programs in 1993 and 1994 in their effort to get macroeconomic performance back on track. However, it is clear that the mixed performance under these programs threatened to keep the medium-term outlook at a precarious crossroad, with all that that implied for the erosion of hard-won domestic and external confidence. The move to secure a three-year ESAF arrangement with the Fund, therefore, signals a welcome shift to increased discipline in the implementation of stabilization measures, although some might view the resumed use of Fund credit as a failure of past reform.

I support approval of the requested ESAF arrangement, and hope that there will be early positive results that will serve to reinforce confidence in the declared commitment of the authorities, and in the credibility of their policies. As a start, confidence should be helped by the fact that the authorities do not intend to seek any debt rescheduling during the life of the ESAF arrangement, even though the stock of public external debt has increased substantially since 1992 and the debt-service ratio is expected to remain high--in excess of 25 percent. Beyond that, much will depend on the resolve with which the authorities control monetary and fiscal aggregates to rein in inflation, and encourage private saving and investment. I endorse the general thrust of the staff appraisal, and would like to make three specific comments.

First, the authorities face an immediate test in controlling inflation. The staff supplement indicates that 12-month inflation in April 1995 jumped to 50 percent, partly as a result of the substantial monetary expansion that occurred in late 1994. Was this level of movement in consumer prices already taken into account when 12-month inflation was projected at 19 1/2 percent for 1995, and if not how great is the likelihood that policies will be kept sufficiently tight to achieve this inflation target? Here, I agree fully with the strategy of establishing the requirement to end central bank financing of the petroleum corporation as a performance criterion.

Second, in the fiscal area, I join in encouraging the authorities to maintain their resistance to pressures for any excessive increase in the public sector wage bill, in order to avoid the entrenchment of a wage-price spiral, and to prevent the crowding-out of expenditure in critical areas, such as a well-targeted social safety net. The essential challenge for the authorities here is the breaking of inflationary expectation, and

I believe that experience elsewhere has shown that courageous resistance to pressures to inflate public sector wages, combined with a tight monetary stance, will eventually bring inflationary expectations in line.

Finally, I note with interest that the authorities have abandoned the value-added tax in response to the disturbances triggered by its introduction, and have reinstated the sales tax. However, Mr. Mirakhor's statement holds out the possibility of the value-added tax being reintroduced at some point in the future. Notwithstanding the much acclaimed superiority of the value-added tax as a tax measure, and as it's reintroduction might seem provocative in the view of the populace, I invite the staff or Mr. Mirakhor to comment on whether thought was given to orchestrating the application of the sales tax so that, in the end, the authorities would achieve approximately the same objective being sought under a value-added tax.

The staff representative from the African Department noted that, although the authorities were concerned about the overall price impact of deregulating prices in the petroleum sector, they had agreed to the use of a formula, under which the retail prices on petroleum products would be adjusted in accordance with movements in international oil prices, movements in the exchange rate, and movements in freight margin marketing costs. Under that formula, which would be used for a transitional period, every effort would be made to adjust prices in the petroleum sector in a way that would duplicate full market pricing. Following that transitional period, it was to be hoped that the formula could be eliminated in order to allow for full price decontrol.

The proposed program was geared toward expanding the nontradable goods sector by promoting both exports and import substitution, the staff representative stated. According to preliminary calculations, the measures included under the program should result in an increase in the volume of exports to a level that would exceed GDP growth by about 2-3 percent.

The medium-term scenarios were based on an assumption that the price of gold would increase by about 1.5 percent a year and that the price of cocoa would rise by about 2.5-3 percent a year, the staff representative commented.

The staff projection for an inflation rate of 50 percent through April 1995 was attributable to the impact of the rapid expansion in broad money in late 1994 and the price effect of the value-added tax, the staff representative noted. As Mr. Mirakhor had indicated, following the introduction of the value-added tax, producers and traders had increased prices sharply, without realizing that they would receive a tax rebate. Therefore, the value-added tax had caused a tremendous jump in prices.

Nevertheless, in the period since the value-added tax had been rescinded, many prices increases had been rolled back. Thus, the effects of the decrease in prices should begin to pass through to the consumer price index in May and June 1995.

It should also be noted that the consumer price index in Ghana was very sensitive to climatic conditions, the staff representative continued. Even in periods of relatively high inflation, the consumer price index could normally be expected to decline to negative levels in the two or three months following the wet season.

Based on the above-mentioned considerations, the staff was relatively confident that, if the Government adhered to its very tight monetary stance, it would be possible to meet the ambitious inflation target--of 20 percent--incorporated in the program, the staff representative went on.

The staff would continue to look for innovative ways in which the value-added tax could be reintroduced in Ghana, the staff representative from the African Department stated. As the Government had been impressed by the revenue performance of the value-added tax, it would likely be in favor of replacing it fairly quickly. Nevertheless, there was clearly a need to do a little more--in terms of preparing the public for such a tax--than just reintroducing the tax under a different name.

Mr. Mirakhor thanked Directors for their comments, which would be conveyed to his Ghanaian authorities. They would likely find the current discussion useful, as many of the points raised by Directors pertained to matters that were currently a focus of attention in Ghana.

Over the next few years, the authorities' highest priority would be to reduce inflation to levels that would facilitate the achievement of growth objectives, Mr. Mirakhor said. Indeed, the effort to combat persistently high rates of inflation had been a constant source of frustration for the authorities. Since the main factors contributing to the high rates of inflation--including the problems of the national oil company--had been identified, the authorities had moved quickly to address them, even in the face of difficult political circumstances. Moreover, the proposed program was well-designed and sufficiently ambitious. Therefore, there was reason to be optimistic that the authorities' anti-inflation objectives would be achieved.

It should be noted that the political liberalization achieved in Ghana in 1993 had really changed the character of the country, Mr. Mirakhor considered. The political structure was now much more vociferous than it had ever been in the past. Moreover, adjustment fatigue was becoming a fundamental issue in the economy; if prices did not decline, or if real incomes did not rise, quickly, serious social problems would likely emerge.

For that reason, the successful completion of the proposed program would be critical for Ghana.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They noted that, following the successful completion in early 1992 of the program that was supported by an enhanced structural adjustment arrangement, Ghana's economic performance had weakened. Rapid monetary expansion in 1994, fueled by heavy borrowing by the national oil company from the central bank, had led to an intensification of inflationary pressures. Private saving and investment had remained weak, and economic growth had been uneven. The authorities now needed to regain policy credibility and reaffirm their commitment to poverty alleviation and sound macroeconomic policies.

Directors therefore welcomed Ghana's new economic program for the period 1995-97, which aims at raising the growth of output by establishing a stable financial environment supportive of private sector initiative and domestic and foreign investment. They noted the difficulties that the Ghanaian authorities had faced in the early stages of implementation of the program, including a temporary outbreak of civil unrest, which had regrettably led to the rescission of the new value-added tax. In the circumstances, the fiscal actions taken by the Government were a balanced response to public concerns that, at the same time, safeguarded the overall fiscal objectives of the program.

Directors emphasized the critical importance of fiscal discipline and of bringing the rate of inflation under control, as a condition for the restoration of sustainable growth. They, therefore, expressed concern about the continued large increases in government wages and the potential for a wage-price spiral. They urged the authorities to exercise wage restraint in line with the program so as to maintain fiscal discipline and protect Ghana's external competitiveness. In this connection, more rapid civil service reform was recommended. Directors also emphasized that proceeds from the divestiture of public assets should be used for purposes of debt reduction or the acquisition of productive assets. Furthermore, they emphasized the urgency of completing arrangements for the establishment of an effective expenditure monitoring and control machinery. Meanwhile, every effort should be made to ensure that no new arrears to domestic suppliers will arise and that outstanding arrears will be settled as quickly as possible.

With respect to the mix of stabilization policies, Directors supported the strategy of assigning monetary policy the task of bringing down the rate of inflation, while using the exchange rate to meet the program's foreign reserve targets. Some suggested that, once substantive progress has been made in stabilizing prices and establishing a comfortable level of foreign exchange reserves, it might be appropriate to consider using the exchange rate as a nominal anchor to hold inflation rates down, but in general Directors urged caution. They emphasized that it was the strength and credibility of financial policies that would be critical in sustaining low rates of inflation.

Directors noted that structural reforms would be focused on the removal of state involvement in those areas of economic activity that could be better handled by the private sector, which should be turned in to the moving force in the economy. They welcomed the Government's commitment to accelerate the divestiture program and their plans to deregulate the petroleum sector and to address the acute financial difficulties of the national oil company. They urged the Government to move vigorously to ensure that the timetable for deregulation was strictly observed. Directors also supported the planned measures to liberalize the cocoa sector.

In sum, Directors endorsed Ghana's program whose firm implementation would lay the basis for higher levels of private saving and investment and, therefore, enhanced growth. In support of the program, Directors also approved a new three-year enhanced structural adjustment arrangement, which was expected to bolster donor confidence and help the authorities mobilize the resources needed to meet Ghana's external objectives, including the elimination of external payments arrears.

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

The Executive Board took the following decision:

1. The Government of Ghana 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 Ghana (EBD/95/63).

3. The Fund approves the arrangements set forth in EBS/95/76.

Decision No. 11025-(95/64), adopted
June 30, 1995

5. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mrs. Wagenhoefer on the completion of her service as Alternate Executive Director for Germany.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/95/63 (6/28/95) and EBM/95/64 (6/30/95).

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/105 (6/27/95) and EBAM/95/105 Supplement 1 (6/28/95) and by Advisors to Executive Directors as set forth in EBAM/95/105 (6/27/95) is approved.

APPROVAL: January 10, 1997

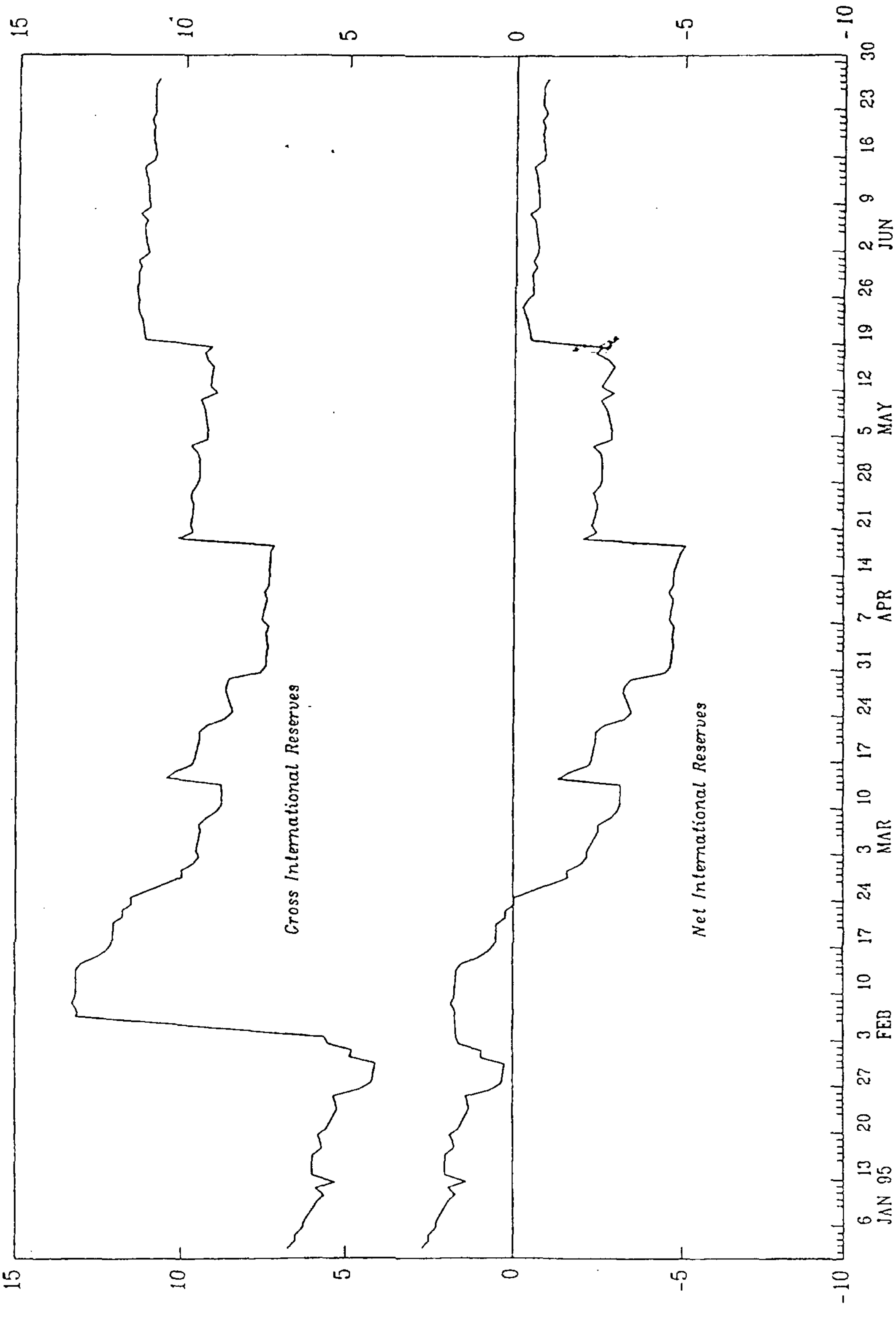
REINHARD H. MUNZBERG
Secretary

CHART 1

MEXICO

Gross and Net International Reserves

(In billions of US$)



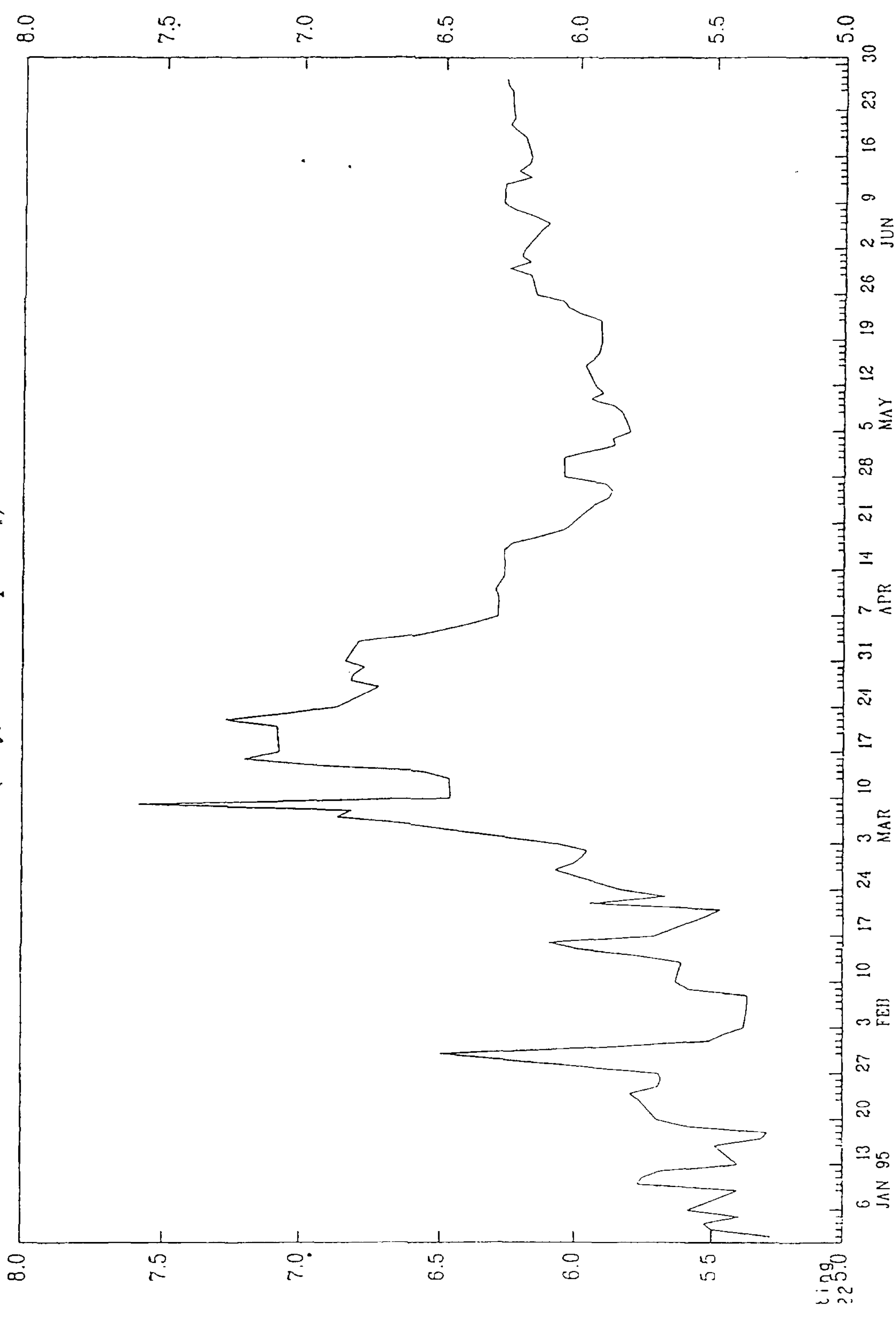
Source: Bank of Mexico.

CHART 2

Mexico

Exchange Rate

(Daily, New Pesos per US$)

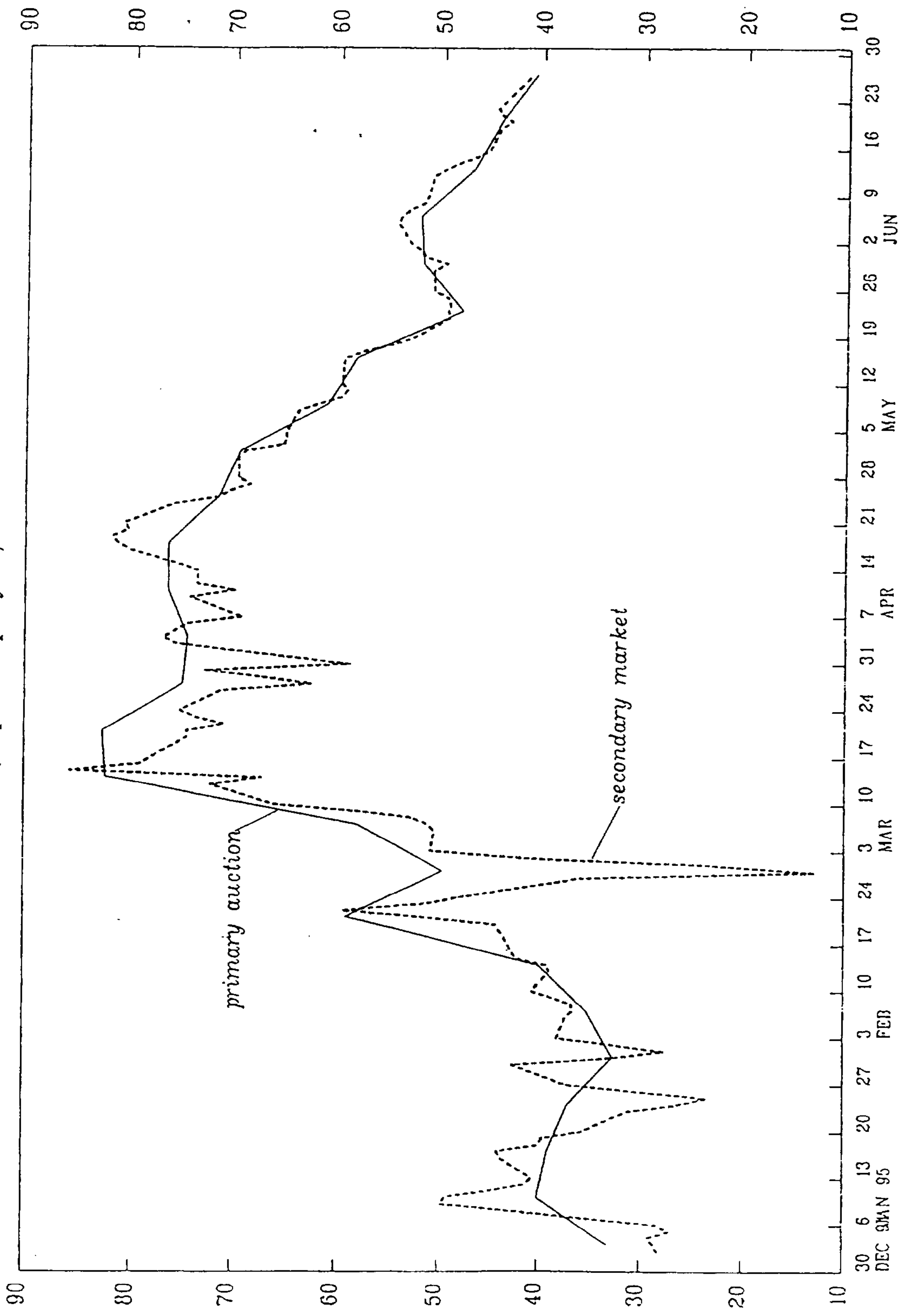


Source: Bank of Mexico.

CHART 3

MEXICO

28-Day Cetes Interest Rates
(In percent per year)



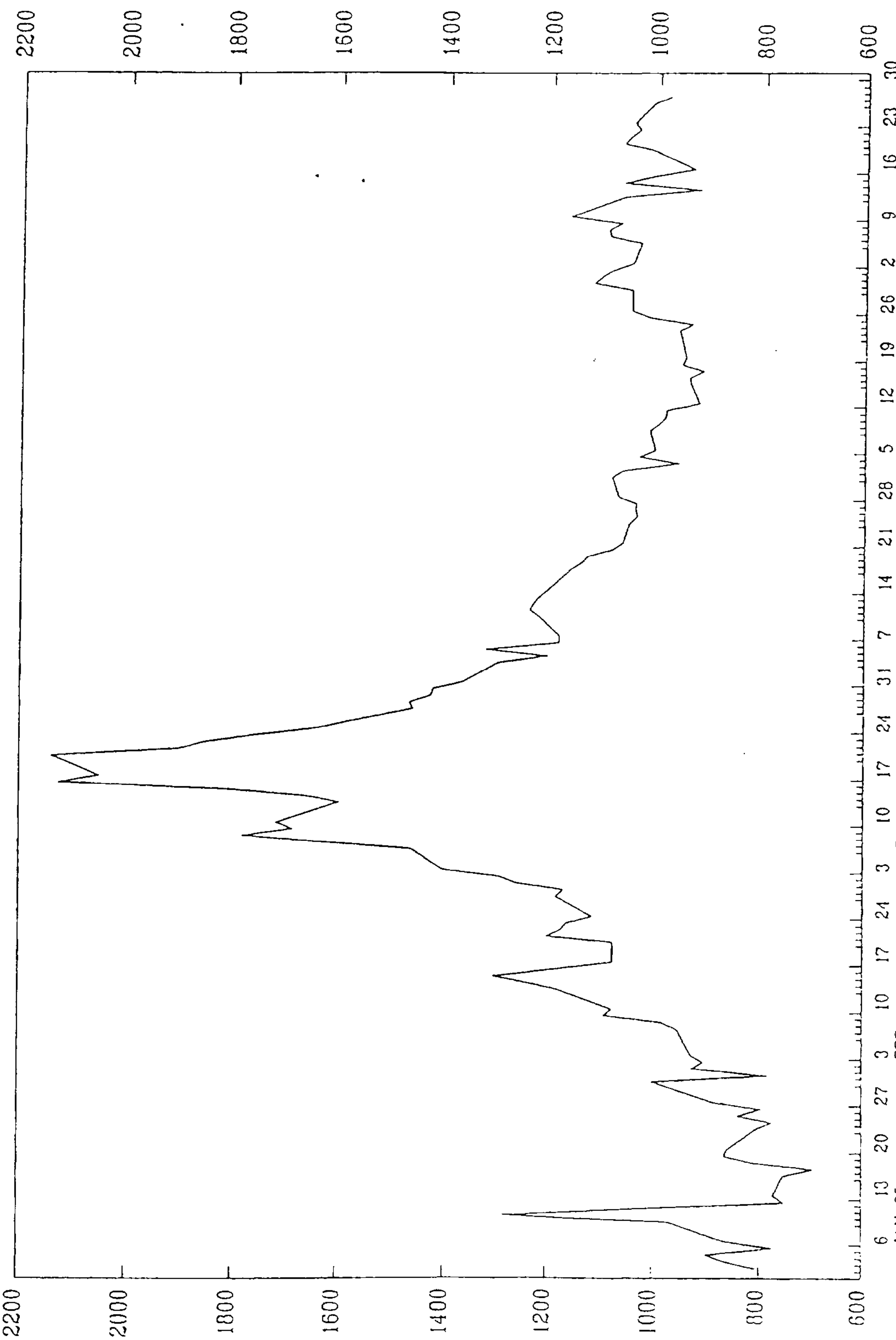
Sources: Bank of Mexico.

CHART 4

MEXICO

Brady Bonds Stripped Spread

(In basis points)



Sources: Salomon Brothers; Reuters; and staff estimates.

CHART 5

Mexico

Stock Market Index

Source: Bank of Mexico.

To: Mr. Loser
Mr. Boorman

June 28, 1995

From: Marc-Antoine Autheman (sd.//)
Huw Evans (sd.//)
Daniel Kaeser (sd.//)
Willy Kiekens (sd.//)
Giulio Lanciotti (sd.//)
Stefan Schoenberg (sd.//)
Eva Srejber (sd.//)
J. de Beaufort-Wijnholds (sd.//)

Subject: MEXICO - Second review under the stand-by arrangement

Adjustment of the Mexican economy appears to be proceeding satisfactorily: since February, there has been a dramatic turnaround in external trade accounts with a concomitant substantial reduction in the forecast for the 1995 current account deficit; financial market confidence is steadily being rebuilt and amortization of official debt instruments is progressively becoming easier; there has been a recovery in net international reserves since our last review; furthermore, the Mexican authorities, including most recently Minister Ortiz, have repeatedly asserted their confidence that they will not need to draw on all the resources committed by the Fund.

In this context, we believe it useful and appropriate to consider alternatives to the staff's proposed decision for the second review of the stand-by arrangement with Mexico.

The first alternative would consist of re-asserting the full extent of the Fund's financial commitments to Mexico, of scheduling part of the purchases at the time of this second review (for instance, the first two purchases) and of leaving scheduling of additional purchases for future reviews. We note, in this respect, that performance criteria have not been defined for 1996.

A second alternative, which we would be ready to consider if appropriate language could be agreed upon, would be to include in the summing-up of the discussions a statement that the balance of payments need should be very carefully considered with the authorities prior to each purchase under the arrangement, and that there is a presumption that, beyond the August purchase, the arrangement will be of a precautionary nature.

For further consideration of this issue, we would appreciate it if you could circulate an alternative draft decision along the above-mentioned lines.

cc: Managing Director
Deputy Managing Directors
Executive Directors

To: Executive Directors June 29, 1995

From: Luis E. Berrizbeitia (sd.//)
Javier Guzmán-Calafell (sd.//)

Subject: Comments on the Suggestions by Several Directors Concerning Mexico's Second Review Under the Stand-by Arrangement

With respect to the proposal submitted by a number of Directors to the staff, suggesting alternatives to the decisions proposed in the staff report on Mexico (SM/95/153), we would like to make the following comments:

Regarding the first alternative, our Mexican authorities strongly support the calendar of purchases of Fund resources proposed in the staff report. While the intention of Mexico, as expressed repeatedly, is not to make further purchases after August, if present trends continue, my authorities consider that it is very important to give the signal to markets that the full amount of committed Fund resources is available, and that a calendar has been agreed for the use of these funds, as this would strengthen confidence in the economic program. It is the view of our Mexican authorities that postponing to a future Board meeting the decision on the amounts to be disbursed after August, could create additional uncertainty in the markets, that could eventually result in the need for more purchases than would otherwise be the case.

The decision proposed by the staff adheres fully to the precautionary spirit of stand-by arrangements. In this respect, it is interesting to quote some of the reflections on stand-by arrangements of Sir Joseph Gold, a most eminent legal mind and General Counsel at the Fund for many years: 1/

"Often, countries do not need additional resources at once but feel that possibly they may need them at a somewhat later date. Their current plans, however, may be affected by the degree to which they can be sure of access to resources if they do become necessary. The benefits of this assurance are recognized by Article I, which declares that it is a purpose of the Fund to give confidence to members by making the Fund's resources temporarily available to them under adequate safeguards. It was

1/ Sir Joseph Gold, The Stand-By Arrangements of the International Monetary Fund, 1970, p. 23.

thought desirable, therefore, that a procedure should be found by which members could make purchases during a defined period, if the need should arise, without review by the Fund of each request as if it were made de novo."

It is also worth quoting an analysis of the Treasurer's Department on the operations of the Fund published a few years ago: 1/

"Since adjustment is a continuing process, it is essential that Fund support for the member's adjustment policies be available through the period of the arrangement ... Phasing, like performance criteria, is intended to make the Fund's conditionality effective, and the two together not only provide safeguards for the proper use of the Fund's resources but also enable a member to demonstrate to other lenders that its adjustment program is being implemented and warrants continued support".

Regarding the second alternative, we would like to refer to SM/94/299, p. 2:

"The Fund may not challenge a member's representation of need made in the context of a request for a reserve tranche purchase or a purchase under a stand-by or extended arrangement. Accordingly, if all the conditions prescribed in the arrangement have been met, the Fund must meet the purchase request. However, in the case of either a reserve tranche or a purchase under an arrangement, the Fund may take remedial action after the purchase is made if it determines that the purchase took place in the absence of need."

We therefore request that our colleagues take into account the views of our Mexican authorities on these issues, and that they also consider carefully the precedents that may be established by proposals of this nature. Finally, we wish to reiterate our Mexican authorities' expectation that there will not be further purchases of Fund resources after August.

cc: Managing Director
Deputy Managing Directors
Mr. C. Loser, WHD
Mr. J. Boorman, PDR

1/ Financial Organizations and Operations of the Fund, Treasurer's Department, International Monetary Fund, 1991, p. 56.