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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/113

10:00 a.m., December 21, 1994

Contents

Executive Board Attendance

P. R. Narvekar, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
M.-A. Autheman	L. Fontaine, Temporary
J. Bergo	E. Srejber
	A. Galicia, Temporary
	R. Rainford, Temporary
	J. M. Jones, Temporary
	J. O. Aderibigbe, Temporary
	J. Shields
	R. Glennerster, Temporary
K. P. Geethakrishnan	R. Kannan, Temporary
	N. Prasad, Temporary
	L. M. Cheong
	A. M. Koulizade, Temporary
A. Kafka	A. Calderón
	J. Prader
	V. Rigász, Temporary
	D. Saha, Temporary
G. Lanciotti	N. Coumbis
	G. Schlitzer, Temporary
K. Lissakers	B. S. Newman
	T. Oya, Temporary
A. Mirakhor	H. Golriz, Temporary
	A. G. Zoccali
	E. Wagenhoefer
A. S. Shaalan	Y. Y. Mohammed
D. V. Tulin	
E. L. Waterman	J.-H. Kang
	M. Petrie, Temporary
J. de Beaufort Wijnholds	G. H. Huisman, Temporary
	Wang Y., Temporary

L. Van Houtven, Secretary and Counsellor
T. Ranaweera, Assistant

Also Present

IBRD: N. B. Tallroth, Central Western Africa Regional Office; J. D. Lewis, East Asia and Pacific Regional Office. African Department: E. A. Calamitsis, Director; C. Brachet, Deputy Director; J. K. Cady, M. Nowak. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; Y. Horiguchi, Deputy Director; D. J. Donovan, D. C. Ross, L. M. Valdivieso. External Relations Department: H. P. Puentes. Legal Department: F. P. Gianviti, General Counsel; H. Elizalde, R. C. Baban. Policy Development and Review Department: T. Leddy, Deputy Director; J. P. Pujol. Southeast Asia and Pacific Department: L. M. Koenig, Deputy Director; M. Cangiano, C. H. Lim, J. Somogyi. Treasurer's Department: C. A. Hatch. Western Hemisphere Department: C. M. Loser, Director; J. P. Amselle, M. Bonangelino, G. P. Guzman, A. M. Leone, B. S. Stuart. Office of the Managing Director: S. Sugisaki, Special Advisor; M. A. El-Erian, J. Prust. Advisors to Executive Directors: R. F. Cippa, S. K. Fayyad, J. Guzmán-Calafell, J. Justiniano, J. Leiva, Y. Margoninsky, F. Melhem, Yang X. Assistants to Executive Directors: S. Al-Huseini, R. N. A. Ally, J. A. Costa, D. Daco, D. Desruelle, G. El-Masry, J. C. Estrella, R. Ferrillo, C. Gaseltine, M. Giulimondi, C. M. Gonzalez, A. Guennewich, P. Jilek, T. Kanada, W. C. Keller, E. Kouprianova, T.-M. Kudiwu, N. Laframboise, K. J. Langdon, B. M. Lvin, J. Mafararikwa, H. Petana, C. F. Pillath, M. W. Ryan, A. Sighvatsson, V. Trivedi, V. Verjbitski, R. von Kleist, J. B. Wire.

1. RUSSIAN FEDERATION - REPORT BY STAFF

The staff representative from the European II Department said that, during the previous three weeks, the staff and the Russian authorities had worked on a statement of economic policies for 1995, which would be the basis of a program that could be supported by a stand-by arrangement with the Fund. It had not been possible to reach agreement on two important matters: the budget for 1995; and the oil export regime.

The Russian authorities had proposed an adjournment of the discussions, in part because they needed more time to re-estimate the budget in the light of the staff's recommendations, and in view of recent negotiations between the authorities and the Duma--the lower house of the Russian Parliament, the staff representative commented. They also wished to consider possible additional revenue measures, and to appraise the oil export regime for 1995 in view of the objections raised by both the World Bank and the Fund.

The difference between the authorities' and the staff's estimates of the unfinanced budget gap had been about 3 percent of GDP, the staff representative commented. Staff estimates indicated that the budget submitted by the Government to the Duma implied a federal deficit of 10 percent of GDP. However, the maximum level of deficit financing consistent with a reduction in inflation to a monthly rate of about 1 percent by the end of 1995 was about 7 percent of GDP. Therefore, the staff had asked for the identification of deficit reduction measures amounting to an additional 3 percent of GDP.

Because of uncertainties about implementation and the expected yields, the staff had reservations about some of the revenue measures already incorporated in the budget, the staff representative explained. After lengthy discussions with the authorities, and an understanding that a number of revenue measures amounting to about 1 percent of GDP would be adopted as prior actions, the staff had agreed to incorporate them in its budget estimates.

In addition, the Russian authorities had identified another 1 percent of GDP in new revenue measures that had not been included by the authorities in the original budget, the staff representative explained. Thus, some progress had been made in identifying new revenue measures, and therefore in reducing the prospective fiscal deficit by some 2 percent of GDP. The authorities had also agreed with the staff that the planned issue of 4 percent of GDP in domestic government securities in 1995 would be excessive, and that a total issue of, at most, 3 percent of GDP would be more appropriate.

Discussions between the Government and the Duma's Conciliatory Commission on the budget had led to a widening of the fiscal gap, the staff representative observed. The approved increase in the minimum wage by 68 percent in March 1995 would increase the fiscal deficit by at least 0.5 percent of GDP, even assuming that the Government would succeed in avoiding any impact of that measure on its wage bill. If it failed to do so, the deficit could be considerably larger. The repeal by the Duma of a tax on exchange rate valuation gains on foreign currency deposits held by enterprises with Russian commercial banks would cost the budget about 0.5 percent of GDP. In view of those developments, the authorities had indicated that they needed time to identify further revenue measures to fill the new budgetary gap. Furthermore, the authorities needed to revise the assumptions in the budget concerning both the exchange rate and inflation.

Monthly inflation in December 1994 was expected to be about 15 percent, which was considerably higher than the 7 percent rate that the Systemic Transformation Facility program had envisaged, the staff representative observed. Therefore, expected inflation and nominal GNP in 1995 probably would be higher than what the authorities and the staff had assumed. Also, the value of the ruble in terms of the dollar and other major currencies was already lower than what had been assumed, with consequences for the ruble value of external financing in 1995, and for the budget.

The authorities and the staff had agreed to resume discussions in January 1995, the staff representative commented. By that time, re-estimates of the budget would be completed, and the situation in the Duma as regards the budget itself and the tax reform--a part of the budget proposal that had not been approved by the Duma--would be clearer.

On the other key issue, agreements with the World Bank on the oil rehabilitation loan, and the second Systemic Transformation Facility with the Fund, had committed the Russian authorities to abolish oil export quotas on January 1, 1995, the staff representative explained. However, the Government had decided to replace export quotas with a system of mandatory deliveries of 65 percent of total local production to the domestic market. Estimates of both the Russian authorities and the staff suggested that the measure would, in effect, reintroduce export quotas under a different name. Given the current trends in production, it would probably freeze the value of oil exports--or perhaps reduce them marginally in 1995--and would prevent the domestic oil price from rising toward the international price.

By limiting the volume and the value of oil exports, the measure would affect the profitability of oil companies and their ability to pay taxes to the Federal Government, the staff representative continued. Furthermore, it would reduce efficiency, the incentives for further exploration, and in general, hinder petroleum exports. The Fund and the World Bank staff had objected strongly to the proposed system of mandatory deliveries, and had recommended that it be abolished. In that context, there was considerable controversy in Russia; among the authorities, there were many who strongly opposed the system of quasi-quotas, but others wanted to return it, because of the rents it would generate.

Despite those difficulties, considerable progress had been made in other areas, particularly on monetary policy, the staff representative commented. The Central Bank of Russia had decided to stop direct credit--

except seasonal credits--to the Federal Government, and would conduct monetary policy essentially through open-market operations in the secondary market. The staff, the Ministry of Finance, and the Central Bank had reached a number of agreements on credit procedures, debt management, and the types of new securities the Government would issue in order to diversify its portfolio of securities and allow the Central Bank to operate a relatively independent monetary policy.

Mr. Autheman wondered whether the staff representative could elaborate on the new revenue measures proposed by the authorities.

The staff representative from the European II Department said that there were two categories of measures. First, the authorities had agreed to take prior actions on a number of measures already incorporated in the budget, including the introduction of a license fee on alcohol, the removal of all exemptions on the oil export tax--with the exception of oil exported by joint ventures--and the increase in the export tax on natural gas from 0.5 to 5 ECUs per metric ton. Second, additional measures had been proposed by the authorities to close the budgetary gap, including an increase in the export tax on crude oil from 15 to 20 ECUs per ton, the removal of all exemptions on the tax on exports of natural gas, and an increase in the ratio of import duties to total imports, which was to be achieved by eliminating exemptions on import duties and by raising the low duty rate to 5 percent, while lowering some peak rates.

Although the staff was not in favor of any import tariffs, it had accepted that measure in view of the pressing need for revenue and the lack of politically feasible alternatives, the staff representative stressed. Furthermore, much of the increase in the ratio of import duties to imports would result not from an increase in individual tariffs, but from reducing exemptions.

Some zero-duty or very low duty tariffs would be increased to 5 percent, while peak rates--those above 30 percent--would be reduced, the staff representative explained. The net result would be a moderate increase in the weighted average tariff rate, and a sharp decline in the dispersion of tariffs, which would remove distortions and facilitate Russia's future negotiations with the GATT.

2. SIERRA LEONE - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

Executive Directors considered a staff paper on the midterm review under the first annual arrangement under the ESAF for Sierra Leone (EBS/94/226, 12/1/94).

Mr. Jones made the following statement:

The policies and measures taken by the Sierra Leonean authorities under the ESAF arrangement represent further progress down the road of economic reform following the successful conclusion of their rights accumulation program. The cornerstone of the adjustment strategy remains the emphasis in creating a stable macroeconomic environment based on sound monetary and fiscal policies, as well as structural reform aimed at creating conditions for the economy to become more responsive to market forces.

The adjustment experience has been challenging, to say the least. Rebel hostilities continue to constrain economic activity as well as put pressure on military expenditure. Also, the program had to be implemented against the background of less than propitious conditions in the market for Sierra Leone's major exports, bauxite and rutile. These problems, however, have not daunted the resolve of the authorities to move ahead; in fact, the authorities are fully aware of the important need to consolidate the gains of the rights accumulation program.

On the whole, the program remains on track. All but one of the performance criteria for end-September were observed. The breach was related to the delay in adjusting petroleum prices for which the authorities have requested a waiver. The necessary adjustment to petroleum prices was put into effect on December 1, 1994.

The adjustment program is beginning to bear fruit: the fiscal deficit is expected to decline further; the external current account in 1994 is likely to be better than expected; gross reserves are expected to rise by end-1994 to the equivalent of over three months of imports; the exchange rate has been relatively stable; and GDP is expected to grow by 3.5 percent in 1994 which, although lower than the initial forecast, is significantly higher than what was recorded in recent years.

These developments give the authorities reason for thinking that the adjustment strategy they have adopted is the right one, and no significant changes are envisaged. The immediate challenge is to contain inflation by keeping a tight rein on financial policies. The authorities are also determined to continue with the process of structural reform in order to lay the foundation for higher rates of economic growth.

In the fiscal area, revenue is expected to pick up as a result of new tax measures, including the increase in sales tax, and improved tax administration. Regarding the latter, the withholding tax on interest income has been raised and rental income has been incorporated into personal income. Benefits-in-kind will become taxable as of April, 1995. Also, measures are being taken to improve customs tax collections, and to revise preshipment inspection operations.

On the expenditure front, three points ought to be mentioned. First, the authorities are committed to reducing military outlays by the equivalent of 0.4 percent of GDP in 1994/95. To ensure efficiency, all spending commitments by the military will have to be authorized by a special committee, and technical assistance is being sought to ensure that military equipment is procured at competitive prices. Second, the increase in the Government's wage bill is expected to be contained within the agreed limits, translating into a slight decline relative to GDP. Third, the authorities hope to achieve economies in the development budget.

The combination of these and other measures should result in a further decline in the budget deficit in 1995 to 5.2 percent of GDP, less than half of what it was at the beginning of the 1990s.

Monetary policy will focus on containing inflation. It is expected that inflation will decline in 1995, reversing the fall in real interest rates on financial savings. Although monetary policy will remain tight, the authorities will ensure that sufficient credit is made available to the private sector. The Bank of Sierra Leone intends to continue with the use of open market operations as the major instrument of its monetary policy.

Efforts are being made to improve the functioning of the banking system. The "holding actions" taken in 1993 have already succeeded in strengthening the capital adequacy of the banks. The authorities are in the process of formulating new banking legislation, with technical assistance from the Fund and the World Bank, aimed at increasing the autonomy of the central bank and reinforcing its supervisory role.

Regarding structural policies, it should be noted that the civil service reform program is proceeding on schedule. It is no small feat that by the end-September 1994 the ranks of the civil service had been reduced by 40 percent from July 1, 1991. The authorities continue to attach priority to the reform of public enterprises. In this regard, the oil refinery and cement company have recently been sold, and there are plans to sell the Government's share in the National Petroleum Company.

On the external front, receipts from Sierra Leone's major exports, bauxite and rutile, are expected to rise over the medium term owing to improved prospects for world demand. Diamond exports are also expected to pick up. Imports, which have been depressed, are expected to increase as the security situation improves, leading to increased economic activity.

Recognizing the importance of regularizing relations with creditors, the authorities have taken significant steps to address the problem of external arrears. Agreement has been reached with Paris Club members on concessional rescheduling of debt service payments falling due through the end of 1995 on concessional terms, while the issue of commercial bank debt is to be addressed through a debt buy-back operation that will be put into effect during the first half of 1995.

In sum, favorable developments are beginning to emerge in the Sierra Leonean economy. The authorities are encouraged by this and intend to stay the course of adjustment through prudent economic management. However, adequate and timely external assistance will be critical to bringing the economy to a successful landing.

Mrs. Cheong made the following statement:

Sierra Leone's economy has performed satisfactorily, despite the domestic security problem. Most performance criteria have been comfortably met, with a most notable exception of a slippage in the inflation target for 1994 by a somewhat large margin, which apparently is not solely due to a policy-induced factor. Despite the encouraging progress, I note that the economy lacks a driving force for accelerated growth. Inefficiency in the financial sector seems to play an important role in impeding the growth of private investment, which contributes to the sluggish pace of economic growth.

Following the removal of an interest rate floor, deposit rates fell from 23 to 8 percent, becoming negative in real terms. Correspondingly, over the same period, lending rates declined markedly, from 40 to 26 percent. The spread between lending and deposit rates, however, remained unchanged at around 17 percent, a level which is too high by any standard. In my observation, there are some factors contributing to this extremely high level of spread. First, business risk may be higher than the normal level, a factor which is expected given the domestic security problem. Second, the reserve requirement is set at a high level of 30 percent, which has contributed to raising the cost of intermediation. Third, the banking sector may not operate efficiently because of stifled competition.

Developments in the fiscal area seem to complement those in the monetary sector to disfavor investment. With a high corporate tax rate of 47.25 percent--despite a plan to eliminate a surtax on corporate tax of 2.25 percent--combined with a lending rate of

26 percent, it is indeed difficult to identify a project area which yields a positive return on investment. Such a phenomenon is reflected in the low ratio of private investment to GDP of only 6.8 percent and is projected to increase marginally to 7 percent in 1996, a level which is even lower than that in 1991, a period before the launching of the reform program.

While Sierra Leone has performed well in meeting program targets, some added push is necessary for the economy to take off on a more sustainable growth path. Several measures to revitalize economic growth could be considered. First, business risk should be reduced by improving domestic security. I believe that the Sierra Leonean authorities have already put this on their agenda.

Second, some easing of monetary policy is possible without raising the level of inflation rate. We note that the inflation rate remains high despite nominal expansion of money stock by only 2 percent. As the staff acknowledged, the cause of the inflation seems to be more cost-push factors of a "one-off" nature, such as the near-doubling of the import prices for rice and price increases owing to weather conditions. Several of my constituency countries have found specific measures to address such one-off factors in price increases to be quite effective. While monetary policy should remain tight, it should also not dampen investment initiatives.

It may be possible to have specific measures to address the supply factors causing price increases and ease money growth a little to stimulate economic activity. In this regard, reserve requirement ratios could be reduced from the 30 level to lower the cost of intermediation and, of course, the cost of funds to investors. A careful balance between a reasonably tight monetary policy and, say, reduction in tariffs to ease supply constraints, could help address inflation and, at the same time, induce new investments. Any subsequent increase in imports would not be inconsistent with developments in the external sector. As the staff pointed out, some import increases could meet medium-term investment targets. Of course, over the medium term, one should monitor closely the composition of imports by end-use to ensure that purely consumption goods do not account for a greater share of total imports.

Third, the banking sector should be reformed so as to allow greater competition, which will promote efficiency.

Fourth, on the fiscal front, I would say that a lower rate but a broader-based corporate tax would be more conducive for investment. In this regard, more attention should focus on the corporate tax to stimulate investment. Given the inflation level against a low investment to GDP ratio, a bigger reduction in the corporate rate with only a nominal reduction in personal income tax would seem more appropriate. The staff may wish to comment on these suggestions.

Finally, I welcome the authorities intention to accept the obligations of Article VIII of Fund's Articles of Agreement and support the staff's recommendation for extension of exchange restrictions until the conclusion of Article IV consultations. Given the adherence to all other program targets and the satisfactory performance of the public sector, I also have no difficulty in endorsing a waiver for the nonobservance of the program performance criterion relating to petroleum pricing.

Mr. Kannan made the following statement:

It is encouraging to note that the policy performance under the program has generally been good, and all the performance criteria for end-September 1994 were observed. In order to consolidate the benefits on a durable basis, we encourage the authorities to continue the reform process with the same vigor of commitment.

The marginal increase in the rate of inflation to 16 percent in 1994 from 15 percent in 1993 is an important area, which will preoccupy the attention of the policy makers in the coming months. Drastic reduction in this rate is possible only if it is accompanied by necessary fiscal and monetary policies. Hence, reduction of the fiscal deficit is an important step, and in this context containing the wage bill, as envisaged under the program, is an important ingredient. However, given the macroeconomic set up, is it not too ambitious to expect a sharp reduction in the inflation rate to 8 percent in 1995, which is almost half of the rate in 1994? Staff may like to comment.

In order to stimulate the private sector and to ease supply conditions, the adoption of appropriate monetary policy instruments is very important. Staff may like to explain the reasons for the slackness in the private sector demand for credit. Does it strongly indicate the lack of business potential, or an inappropriate regulatory environment?

The staff has indicated that money supply would provide the nominal anchor to the financial system. But in the last three to four years, we notice a wide fluctuation in the growth of broad money and in reserve money, indicating that no stable relationship between the two variables is emerging. Hence, to strengthen the nominal anchor role of money supply, its wide fluctuations must be controlled.

Furthermore, it is important to move toward market-determined interest rates. The recent decline in interest rates did not have any impact on savings, as the savings ratio is much below the threshold level. But once it is crossed, positive real interest rate is an important determinant in boosting the savings climate in the economy.

We encourage the authorities to enact the Banking Act as early as possible. The improvement of capital adequacy of banks and the formulation of restructuring programs will strengthen the banking system.

On the external sector, the recent improvement in the trade balance--or the current account--was brought about by the strong import reduction, the impact of which, especially lower capital imports on output growth, is unknown. Once there is a pick up in private sector activities, this may not be available in future. In this context, all attempts must be made to boost exports, which is possible by enhancing competitiveness. The recent strong appreciation of the currency might have eroded some degree of competitiveness. Hence, the exchange rate policy is to be carefully devised so that competitiveness is not eroded, but at the same time it avoids imported inflation.

We recommend the proposed decision.

Mr. Newman made the following statement:

Sierra Leone's performance has been quite good under the ESAF, even though the economy has taken off more slowly than expected owing to the continuing security difficulties and the soft global market for key mineral exports. The strengthened reserve position and the Government's strong efforts to implement the civil service reduction program are two particularly noteworthy developments since the inception of the program. We support completion of this review, and have just a few comments on issues raised in the staff report.

In the fiscal area, the combined pressures for continued deficit reduction and increased spending on social sector needs and infrastructure projects leave little alternative to increasing revenues. We thus support the proposed improvements to the tax system, and hope they can be put in place over the course of the next arrangement. More immediately, we are pleased to see that the interim solution to the longstanding fisheries surveillance problem is generating revenues, but the negotiations for a permanent surveillance arrangement need to be completed as soon as possible.

On the expenditure side, we welcome the steps to improve control over and transparency of military expenditures. However, we are concerned that military spending has again exceeded expectations and urge the Government to follow through firmly on its commitment to cut such spending.

On the other hand, once the Government completes the civil service reduction program, we could support the intention of increasing pay levels to reduce the extreme disparities that exist, but it seems that increases could be more selectively targeted rather than just granted across the board to the civil service and the military. Perhaps the staff could comment.

On petroleum pricing, the practice of periodically adjusting the price appears to date back to early 1990. To depoliticize this issue and remove the possibility of future budgetary problems arising from lagging adjustments, we see no reason why the Government should not free the price altogether at this time, and wonder whether the staff could comment as to why they are not recommending this option.

In the monetary area, we agree that the original inflation targets for 1995 should remain even though the current rate of inflation is well above the expected level for end-1994. If the expected reduction in inflation does not materialize relatively soon, we would be interested in the course of action that the staff recommends. In the financial sector, we are pleased to see that the Government acted promptly to cleanup the problems that cropped up late last year. With this episode behind it, we would be interested in hearing more about any further plans the Government has to increase financial intermediation inside the official banking system, especially in view of Ms. Cheong's comments about the numerous disincentives that now exist.

Finally, in the area of privatization, we are pleased to see that a number of assets have been sold, but urge the Government to follow through quickly with its plan by selling or otherwise disposing of the remaining companies on the list, such as the hotels.

Mr. Saha made the following statement:

We are very much encouraged by the positive economic developments that are taking place in Sierra Leone. Above all, we note that most of the performance criteria for end-September 1994 were met. Seen against the background of continuation of domestic conflict and unfavorable world commodity prices, this gives us cause for optimism that Sierra Leone will continue with the difficult but necessary adjustment path that would allow it to lay the foundation for durable growth and restore normal relations with its creditors.

We are in broad agreement with the staff's focus on the risks that the continuation of the present conflict creates for Sierra Leone's stabilization efforts and on the thrust of the policies needed to maintain the course of the adjustment process. I will make a few comments for emphasis on the fiscal policy and the structural reform aspects of these recommendations.

With regard to fiscal policy, the fiscal adjustment being pursued by the authorities has been instrumental in reducing inflation; however, given the recent upward revision in the 1994 inflation target, the fiscal adjustment stance should be maintained. In this connection, we welcome the various measures included in the recent budget, and encourage the authorities to ensure that these measures produce the desired fiscal outturn. On the revenue side, we support the authorities' efforts to globalize the personal income tax and improve the collection of the corporate tax. The impact of the recent increase in the sales tax and the implementation of the pass-through policy in petroleum pricing, should help the authorities meet their revenue target. We support the authorities' decision to lower personal and corporate tax rates, and at the same time we would encourage them to prepare contingency revenue measures should delays in meeting projected revenue occur. We endorse Mrs. Cheong's views that the actual high tax rates should be reduced through the broadening of the tax base.

On the expenditure side, the progress made in the retrenchment of civil servants should give the authorities an opportunity to strengthen public management. In this connection, while some incentives should be considered in order to retain qualified civil servants, caution should be exercised regarding a general salary increase, given the still-large fiscal deficit. On this, we share the comments made by Mr. Newman. The continued increase in military spending remains a source of concern. We welcome the steps being taken to improve the monitoring and control of military expenditure. However, a lasting solution to the security problem and its impact on the budgetary operation can only come through a peaceful solution to the conflict.

On development expenditure, we regret that savings in the development budget are used as a mechanism to offset shortfalls in budgetary revenue or overruns in current expenditure. Given the substantial amount of financial resources that will be needed to rehabilitate the war-affected regions, we encourage the authorities to maintain or increase the allocation for this category of spending to quickly create an enabling environment for the private sector.

On structural reforms, the authorities deserve commendation for progress made on many fronts, mainly in civil service reforms, fisheries surveillance, the privatization of public enterprises, and the liberalization of the prices, including efforts to liberalize exchange and interest rates. We encourage them to pursue vigorously the privatization of the remaining public enterprises, in order to consolidate the progress already achieved.

In conclusion, there is no doubt that under the ESAF-supported program the Sierra Leonean authorities are making important progress in stabilizing and restructuring their economy. The policy performance under this program to date testifies to the authorities' firm commitment to the adjustment process. However, the outlook remains highly dependent on progress in reaching a permanent settlement on the domestic conflict. We would urge the authorities to continue giving this issue the needed priority to increase the chances of consolidating the progress achieved so far, and to mobilize the much-needed external assistance to reduce Sierra Leone's heavy debt burden.

We support the proposed decisions.

Mr. Schlitzer made the following statement:

Sierra Leone has made remarkable progress toward the restructuring of the economy and the authorities are to be praised for their commitment to economic reforms. The country has a strong potential for growth, because of its rich natural resource endowment, but this is severely limited by security problems and the economy is vulnerable to external conditions.

The current medium-term adjustment program aims at creating the conditions for economic growth and poverty alleviation, by restoring a sound financial environment and stimulating private activity. During 1994, despite the unfavorable domestic and external conditions, policy performance under the program has been satisfactory and all criteria have been met, except for that on petroleum pricing, which has been delayed by only three months.

As I broadly agree with the staff appraisal, I will make just a couple of points.

As noted by other Directors, although real GDP is projected to grow at an average pace of 5 percent in 1995 and 1996, the private sector still appears to be dormant, as indicated by the extremely weak demand for bank credit and the ratio of private investment to GDP, which is projected to remain stagnant at around 7 percent. Certainly the security problem, contributing to increase the riskiness of the environment, is a major cause of low private activity. However, there are also economic impediments, which the Government should remove promptly.

Mrs. Cheong has already suggested some possible areas of intervention. The first one is taxation. The high corporate tax of 47.25 percent does not contribute to stimulate private activity. A second area is the financial sector. Here, though banking nominal rates have systematically decreased in recent years due to the elimination of various floors and ceilings, the interest rate spread has remained unchanged at around 17 percent. This is an indication that the banking sector is still very inefficient. One major factor for the high level of interest rates can be found in the still inadequate banking legislation. Mrs. Cheong observed that the level of the mandatory reserve requirement is too high by international standards. To this, I would add that the discount rate applied by the central bank to commercial banks, which, as I understand from the Appendix to the staff report, has been set at 55 percent since April 1990, and that at the current inflation rate is equivalent to approximately 40 percent in real terms, is also incredibly high. Hence, there is ample room to improve the regulatory framework, in light of the fact that the capital adequacy ratios of commercial banks have recently improved.

I wonder if there are additional measures that the Government might take to directly improve productivity in the private sector, thus increasing the returns on private investments in the medium term. Agricultural productivity, for example, is very low, and output in the rice sector has failed to meet the demand of the increasing population in recent years and, thus, rice imports have steadily grown. The prolonged lack of infrastructures, especially road networks and transportation, have seriously damaged both agricultural productive regions and manufacturing establishments. I would like to know more from the staff on the role of public expenditure in the reconstruction process, as well as on the role of the World Bank in this respect.

Let me finally add that, as large financing gaps will inevitably remain in the future, it is crucial for Sierra Leone's economic development that they be filled. Thus, I support the proposed decisions and wish the authorities every success in their program.

Mr. Shields made the following statement:

I should first like to join in the compliments which others have made to the authorities in Sierra Leone for their perseverance in efforts to restructure their economy and to maintain macroeconomic discipline in very difficult circumstances.

Apart from the delay in implementing increases in petrol prices, the authorities have kept well to their program objectives since the completion of the rights accumulation program. I think it is particularly noteworthy that they have maintained a good performance in collecting revenue, particularly from customs duties. This seems to be in contrast to other countries in the region, which have continued to experience substantial problems. Nevertheless, on the expenditure side, it is crucial that they act further to rationalize civil service pay and employment, and succeed in redirecting expenditure from defense toward such essential services as primary health care and education.

The program itself seems to have been much less clear on the monetary side than on the fiscal side. There are comments in the staff report about monetary policy being tight. Certainly, both public and private sector credit pictures have been weak. These seem to reflect fiscal stringency on the one hand, and poor industrial production and investment on the other. This has led to very low rates of monetary growth. But it does seem as if the central bank has found it difficult to maintain control at times over the levels of nominal interest rates. This may only be a short-term problem, and comparison with current distorted inflation figures gives an artificially low figure for real interest rates. But if inflation continues to be stickier than expected, this might be an area to watch.

I noticed also a little bit of ambiguity in exchange rate policy. There is a strong statement in the staff report about the authorities only intervening in the foreign exchange market to meet objectives for its currency reserves. But this is followed by a comment about creaming off currency to prevent an appreciation. This means that there could be a possibility of an inflationary bias.

Clearly, however, the impact of monetary policy on the domestic economy may be swamped by the effect of changes in the military situation. As long as demand is kept subdued by uncertainty about military problems, and the objectives for lower military spending themselves are met, the problem, I suppose, is more likely to be one of deficient rather than excessive demand.

Meanwhile, there has been better news on the debt front, which would otherwise continue to impede Sierra Leone's recovery. Following Sierra Leone's agreement, on enhanced Toronto terms, in the Paris Club in July on its official debt payments falling due over the life of the current ESAF, we have last week's further breakthrough at the Paris Club. This will bring significant stock of debt reductions for the poorest and most indebted countries, something this chair has been pressing for very hard. It means that the Paris Club will be able to consider Sierra Leone for a substantial stock of debt operation as early as November 1995, if not before, as long as it continues to maintain satisfactory relations with creditor countries and a good track record on this Fund program. We think this is very good news, indeed, for Sierra Leone.

> But in addition to a substantial easing of official bilateral debt, we believe that Sierra Leone's multilateral debt problems need to be addressed in a way that does not rely on repeated new lending by international financial institutions simply to allow previous loans to be serviced. This Board will have an opportunity to discuss this issue in more detail in February. The United Kingdom believes that greater concessionality of ESAF loans through an extended repayment period is desirable for countries like Sierra Leone, that is to say, low-income countries, which would be severely indebted even after a Paris Club debt stock reduction, and who are also significantly indebted to the Fund.
>
> Finally, we are happy to see that progress is continuing to be made on Sierra Leone's commercial debt buy-back operation, being financed in part by the World Bank. We very much hope that this operation will be successful. This will be a crucial step toward restoring normal relations with the international financial community. This itself is vital for Sierra Leone's future prosperity.

The staff representative from the African Department, responding to Mrs. Cheong's comment, said that the staff did not consider that monetary policy was too tight. Loosening monetary policy would prompt a resurgence of demand-pull inflation, and constrain the stimulus for growth. Moreover, any intensification of inflationary expectations resulting from an easing in monetary policy could undermine the increase in savings that had been achieved during the previous year, and would have a detrimental impact on investment. Thus, any easing of monetary policy could be counterproductive.

The structure of the fiscal budget in Sierra Leone was such that there was too much dependence on direct taxation, which distorted savings, investment, and labor supply decisions, the staff representative commented. Indirect taxation tended to be less distortionary, and in the policy framework paper, the Government had made a firm commitment to rely more on indirect taxation.

The Government intended to approach the Fund--both the Fiscal Affairs Department and the Legal Department--for technical assistance for adopting a value-added tax in the near future, the staff representative commented. In the meantime, because of the overall budget constraints, there was little room for further cuts in corporate or personal taxes over and above those already implemented in the 1995 budget.

The inflation objective for 1995 could be achieved as long as money supply growth was kept low, the staff representative explained. Once the nonrecurrent cost-push factors of the previous year had unwound, the country could experience a marked drop in the rate of inflation. The program had assumed an increase in velocity in 1995, which appeared to be conservative. If the velocity did not increase, then inflation could be lower than projected, or the balance of payments outcome could turn out to be better.

Private sector credit was low because the level of business confidence was very depressed, owing primarily to the impact of the security situation in the war-affected areas, the staff representative explained. As a result of the internal security problems, nearly a third of the country's economy was barely operational, which had a dramatic impact on business and investor confidence in the rest of the economy. The low levels of activity had adversely affected the demand for bank credit.

The civil service pay increase had been a first step in the ongoing program to address distortions in public service remuneration and the lack of competitiveness in the civil service vis-à-vis both the parastatal and the private sectors, the staff representative commented. In the context of the second-year ESAF, a properly focused, structured, and comprehensive review of civil service pay would be conducted in 1995. The aim of that exercise would be to improve the efficiency of the administration, without imposing undue demands on the budget, or undermining the international competitiveness of the Sierra Leonean economy.

In the policy framework paper, the Government had made a firm commitment to deregulate petroleum prices, the staff representative observed. Because prices of oil imports were increasing, a difficult political decision had to be made to raise pump prices. The Government would have liked to depoliticize petroleum pricing. Recently, the oil refinery had been privatized, and the National Petroleum Company was expected to be privatized in the first half of 1995. However, the main issue would be the potential problem of the highly inflated margins of the distributors, which induced the World Bank and the Fund to urge the authorities to use an oil price setting mechanism to contain those margins. The World Bank had stipulated the implementation of the oil price setting scheme as a prior condition for the disbursements of its loan for the purchase of oil imports.

If the present monetary stance could be sustained, inflation would drop, the staff representative observed. If, after the supply factors had worked themselves through, inflation would not drop, it would indicate a major problem with the public's perception of government policy in general, and inflationary expectations in particular. In that event, the high level of inflation would need to be addressed, and what was causing high inflation expectations at a time when the underlying posture of monetary policy was tight would need to be identified.

A commercial bank restructuring program was being implemented to improve financial intermediation and competitiveness of the banking system, the staff representative commented. Stringent restrictions imposed for a short period of time had resulted in a major improvement in the financial position of the commercial banks. The commercial banks had launched an aggressive campaign to look for customers.

Because of those developments in the banking sector, a reduction in interest rate spreads from their high levels could be anticipated, the staff representative said. The primary reason for wide spreads had been an effort by the commercial banks to restore their financial position following a major deterioration in the quality of their loan portfolios, which had occurred primarily because of the impact of the security situation on many of their customers.

Several years previously, the discount rate had been 50 percent, the staff representative commented. At present, the discount rate was set at about 1.5 percent above the treasury bill rate. The discount rate had been reduced in line with the structure of interest rates.

The public expenditure program was aimed at improving the economic and social infrastructure of the country, the staff representative explained. The emphasis was largely on roads and on a large hydroelectric power scheme in the north of the country, an area that was currently inaccessible owing to the security situation. Savings in the public expenditure program had resulted, because it had not been possible to reach some of the areas affected by the civil strife. However, such savings had been offset by increased military spending aimed at eliminating or easing security problems in those areas. As the security situation improved, a reduction in emergency defense spending would be realized, but then an increase in development and social sector spending in the war-affected areas could be anticipated.

Mr. Rigász said that despite continued domestic and external difficulties, Sierra Leone had met virtually all the performance criteria of the program. It was encouraging to note that the Government had recognized the need to achieve its security goals without jeopardizing its economic adjustment program, and risking a reversal of stabilization gains already made. Limiting the defense budget to 4 percent of GDP in 1994/95 was evidence of the Government's good intentions. However, until internal peace was established, the outcome of the fiscal program would continue to be uncertain, despite the Government's serious effort to generate new revenues and make further savings. The stabilization of the security situation would also give the Government's divestiture program a boost, because the lack of security was the reason for the low level of foreign investment. Tight demand management policies had brought inflation down to a relatively low level. In 1995, inflation could come down further, provided the tight stance of financial policies could be maintained, with no additional fiscal actions during the year. The planned value-added tax could create some inflationary pressures as well. Perhaps the staff could comment on the fiscal impact of the several thousand refugees living in camps as a result of recent fighting. He wished to support the decision.

Mr. Rainford made the following statement:

> The Sierra Leone authorities are to be commended for the progress achieved in turning the economy away from free fall into chronic imbalances and hyperinflation, while at the same time struggling on a parallel front to contain civil strife and restore

a secure environment in the country. The momentum toward stabilization generated under the rights accumulation program has successfully carried over into the first annual program under the ESAF arrangement, and it certainly has been no mean achievement for the authorities to have maintained this steady course while contending with the rebel uprising. I join in commending them on their observance of all but one of the financial and structural performance criteria under the program up to September; and I support approval of the request for a waiver in respect of the non-observance of the performance criterion relating to the adjustment of petroleum prices.

The authorities will be aware, however, that the satisfaction they must be feeling from successfully meeting the tests under the program should not lead them to rest on their laurels. While the modest resumption of growth in 1993 strengthened in 1994, the outlook is not yet completely assured in view of the prevailing low level of domestic investment, the continuing weak, though improved, fiscal situation, the persistence of serious external imbalance reflected in negative net international reserves, and what the staff has appropriately described as the stickiness of inflation downwards. It is as though progress in the reform and stabilization effort might be reaching a certain plateau, with everything waiting for something strategic to give, so that the pace of further recovery can be quickened. The obvious strategic development that is awaited is the pacification of the country. The boost in confidence that would follow in its wake would most likely bring an increase in domestic private investment, thus setting the stage for the kind of sustained growth that is needed.

It seems that there are important challenges in the fiscal area for the authorities to confront in the meantime. The overall public sector deficit, excluding grants, while declining, remains high, and this in the face of a low revenue to GDP ratio of 14 percent, while expenditure amounts to some 20 percentage points of GDP. Increasing the revenue to GDP ratio even ahead of program targets must therefore be an important objective of the authorities. Having regard to the fairly wide-ranging reforms of the tax system already implemented between 1989 and 1994, the authorities will need to pursue this objective primarily through improved tax collection and administration. Would the staff comment on the scope for improvement in this direction?

On the expenditure side, an important avenue for easing fiscal pressure would be the substantial reduction in military outlays that would become possible when security conditions are normalized. A small reduction of 0.4 percentage point of GDP is already in train in the current year. The combined effect of an increased revenue to GDP ratio and an eventual marked reduction in military outlays could facilitate further narrowing of the fiscal deficit while allowing for improved social outlays and increased public investment. The boost in confidence resulting from settlement of the civil conflict, buttressed by carefully targeted increased public investment and further structural reforms would hopefully generate a marked increase in private investment, all leading to an acceleration of progress beyond the plateau to which conditions might now be tending.

But the key to this lies essentially in the evolution of the security situation. Hopefully this key will not prove too elusive. In the meantime, I wish the authorities well as they hold strain with the support of the Fund and the international donor community.

Mr. Rainford, adding to his statement, said that his understanding of the report and of circumstances in Sierra Leone in the context of the serious security situation was that the reform effort had reached a plateau. Without the restoration of peace, it seemed that further progress in reform would be difficult, although certain key economic issues--such as the high corporate tax rate, and the wide spread between lending rates and deposit rates--had to be addressed even under the current security situation. The key issue, however, was the cessation of the civil strife. Everything seemed to be on hold until the political situation of the country was normalized.

Mr. Golriz made the following statement:

Sierra Leone's overall economic performance during the first year of the ESAF arrangement was quite satisfactory. All performance criteria were met with the exception of petroleum pricing for which corrective measure was taken early this month. As we concur with the thrust of staff appraisal and policy recommendation, we will be brief.

Under the present difficult circumstances, an urgent task seems to be the intensification of efforts to find a peaceful solution to rebel hostilities, which continue to hurt economic activities in the war-affected region, leave adverse impact on general security and confidence situation of other regions, and put a heavy burden on the military budget. Staff report refers to some "positive changes that have recently been made in the military leadership and in the conduct of the war" that we hope would lead to a lasting conclusion of hostilities.

Turning to economic sector, we are pleased to note that the Government has reaffirmed its commitment to sound fiscal and monetary policies aimed at curbing inflation and moving toward external viability. With inflation proved resistent to further decline from its present level of around 15 percent--that is far from single digit of program target--we were somewhat surprised by the staff's conclusion that "no further tightening of policies is warranted." We are particularly interested to know how would interest rates automatically return to positive levels. It appears to us that the authorities will need to reinforce the policies aimed at stabilization of the economy. In particular, they should foster private savings and investment and continue structural reforms.

With fiscal policy almost in good shape, efforts should be concentrated on monetary policy in general and money supply in particular. We note that the Central Bank continues to rely on open market operations through weekly auctions of treasury bills. We note, however, that while inflation is resistent to decline, real yields on treasury bills have decreased sharply as Table 8 of the report reveals. If interest rates are market determined--as staff report suggests--there should be other factors influencing the rates. Staff comments will be appreciated. The present negative yields on treasury bills would reduce their attractiveness and the authorities should stand ready to take necessary measures ensuring continued sound monetary policy.

Structural reforms are generally proceeding well. Civil service reform seems on track and some notable steps have been taken with regard to privatization of state-owned enterprises. The authorities are encouraged to prepare a privatization plan containing priorities and a feasible timetable. Small-scale firms may be privatized first, medium- and large-scale firms can be privatized based on experiences gathered and as consensus is gradually built up.

The authorities' continued perseverance in making progress to normalize relations with their external creditors is welcome. Ongoing negotiation with multilateral institutions and others should proceed with determination. In foreseeable future, however, Sierra Leone remains in need of concessional financial support from bilateral donors and international financial institutions and that requires an assurance of continuation of the structural and financial reform efforts with at least the same pace and firmness that the authorities have so far demonstrated.

Finally, we have found little information in the report on social safety net. Structural adjustments bring about hardships for vulnerable groups and to maintain their support, they should be protected by a well-targeted safety net scheme.

With these remarks we support the proposed decision.

Mr. Fontaine made the following statement:

Sierra Leone's overall policy performance has continued to be broadly satisfactory under the first-year ESAF arrangement: all quantitative performance criteria for end-September have been met. I can approve the proposed decision. I observe, however, that the delay in adjusting petroleum product prices has further complicated the fiscal adjustment called for in the program, notably by absorbing the contingency margin that would have been earmarked for social outlays.

The stabilization components of the program are indeed progressing well, with the important exception of price developments: the budget deficit is being reduced in line with the program's target; broad money growth has been reduced sharply and the external position improved beyond expectations while the exchange rate has stabilized.

On the other hand, the pace of economic recovery remains very slow, mainly because the improvement in the security situation expected at the time the program was formulated did not materialize. Therefore, while I understand this situation might raise some questions on the stance of demand management policies, I would remain very prudent with a view to avoid any backtracking on the stabilization front. I approve, in this regard, the staff's comments on monetary policy.

Indeed, inflation remains relatively high and I wonder whether this program is ambitious and tight enough on this front. The staff report explains that this is the consequence of a number of cost-push factors, but I wonder if the increases in the government wage bill may not fuel inflationary expectations which could conflict with the targets for inflation for the rest of the program period. With a view to avoid losing the benefits from the civil service retrenchment program, while leaving room for real increases for qualified staff, the authorities should rapidly move ahead with the pay structure reform they intend to carry out with World Bank assistance. I am encouraged by Mr. Nowak's indications on the progress that is expected in this area.

Fiscal policy remains constrained by the increase in military expenditures whereas the program objective was also to expand public expenditures so as to achieve the country's economic and social development objectives. This leaves very little margin for relaxing revenue mobilization efforts. The revised appropriations for goods and services and development expenditures are still a cause for concern. The staff's emphasis on the economic consequences of military expenditures and the way they are monitored under the program are welcome but one might also consider contingency measures to ensure that fiscal policy remain on track while protecting priority expenditures if further overruns in military expenditures occur. The staff might wish to comment on this issue.

The staff representative from the African Department said that maintaining the large refugee camps in Sierra Leone had no fiscal impact, because the entire cost was covered by various international development agencies and nongovernmental organizations.

The security situation in the country was a constraint on further progress on the reform front, the staff representative explained. It would be unrealistic to believe that, in the absence of a marked improvement in the security situation--and therefore in consumer, saver, and investor confidence--a significant rise in GDP growth above the rate of population growth would materialize. Therefore, an improvement in the security situation was a necessary condition for any further improvement in growth. In the meantime, the security situation was imposing continuously heavy pressures on the budget. Maintaining a reasonable revenue effort was becoming a strain, particularly in the case of collecting the corporate tax, and the security situation increased the strain on the military budget. Recent negotiations between the Government and rebels through UN initiatives provided a glimmer of hope for the peaceful settlement of the internal conflict.

Contingency measures in the budget designed to maintain priority expenditures in the event of further overruns in the military budget had some intuitive appeal, the staff representative observed. However, the staff would not wish to discuss such contingency measures with the authorities, because that could encourage high levels of military defense spending, and it was the staff's firm view that it was absolutely essential for the Government to maintain a tight limit on military spending. Otherwise, the entire stabilization effort and the substantial gains made over the previous two years could be quickly undermined, and the country could end up with major domestic social upheavals in addition to the rebel war.

In the previous week, the staff had discussed the thrust of the current monetary policy stance with the Governor of the central bank, the staff representative commented. While broad money was within the program target, reserve money had exceeded it. Under the present circumstances, the increases in reserve money would soon be reflected in the broader monetary aggregates. The staff and the authorities had agreed to step up the scale of open market operations to fend off a possible overrun of the money supply target. That would inevitably lead to an increase in nominal interest rates, and, as inflation was already beginning to fall, to an increase in real interest rates over the next few months.

Mr. Jones said that he would convey the observations and comments of Directors to the Sierra Leone authorities. The security situation was a major problem, and it was encouraging to note that some initiatives were being taken to solve it. The authorities were interested in broadening the tax base and further liberalizing the economy, including the banking sector. He wished to assure the Board that the Sierra Leonean authorities were firmly committed to continuing the adjustment strategy, which the Board had endorsed broadly.

The authorities had entered into an ESAF arrangement not as a matter of convenience, but because macroeconomic stability had taken a central position in the political dialogue in Sierra Leone, and there seemed to be a broad consensus that sustained economic reform was a necessary condition for economic recovery, Mr. Jones concluded. The commitment to move forward was only a first step toward the goal of stabilization, which was not an end in itself. The authorities were equally concerned about problems such as unemployment, the health and education of the population, and the alleviation of poverty in general. Such issues of broader economic development had to be addressed through increasing investment in both the private and public sectors. The authorities were prepared to implement appropriate policies, and would need adequate and timely assistance from the international community.

The Executive Board took the following decisions:

Enhanced Structural Adjustment Facility - Review Under First Annual Arrangement

1. Sierra Leone has consulted with the Fund in accordance with paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility (ESAF) for Sierra Leone (EBS/94/35, Sup. 1, 3/24/94).

2. The letter dated November 25, 1994 from the Secretary of State for Finance of Sierra Leone shall be attached to the first annual ESAF arrangement for Sierra Leone, and the letter dated February 14, 1994, together with the attached Memorandum on the Economic and Financial Policies for Sierra Leone, shall be read as supplemented and modified by the letter dated November 25, 1994.

3. Accordingly, the indicators referred to in paragraph 3(a) of the first annual arrangement under the ESAF for Sierra Leone will include the benchmarks set out in Tables 1 and 2 annexed to the letter dated November 25, 1994.

4. The Fund determines that the midterm review contemplated in paragraph 2(c) of the first annual arrangement under the ESAF for Sierra Leone has been completed and that, notwithstanding the nonobservance of the structural performance criterion on the pricing of petroleum products, Sierra Leone may request the second loan specified in paragraph 1(b) of that arrangement.

Decision No. 10869-(94/113), adopted

December 21, 1994

Exchange System

Sierra Leone maintains an exchange measure subject to Fund approval under Article VIII, Sections 2(a) in the form of limitations on the availability of foreign exchange for the payment of external debt obligations, as evidenced by some external payments arrears. The Fund welcomes Sierra Leone's intention to eliminate this exchange measure before June 30, 1995. In the meantime, the Fund grants approval for the retention of the measure until the conclusion of the 1995 Article IV consultation with Sierra Leone or June 30, 1995, whichever is earlier. (EBS/94/226, 12/1/94)

Decision No. 10870-(94/113), adopted
December 21, 1994

3. FIJI - 1994 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1994 Article IV consultation with Fiji (SM/94/280, 11/21/94; and Sup. 1, 12/16/94). They also had before them a background paper on recent economic developments in Fiji (SM/94/290, 12/7/94).

Mrs. Cheong made the following statement:

In 1993, the Fijian economy registered a positive growth rate for the fifth consecutive year. Its deceleration to 1.9 percent was due mainly to supply disruptions and the damage to infrastructure inflicted by the hurricane early in the year. Growth is expected to pick up again, to exceed 3 percent in 1994, based on better performances in sugar and other agricultural production as well as higher tourist arrivals. Significant success has been achieved on the inflation front, with the underlying year-on-year rate dipping to around one-and-a-half percent. Foreign exchange reserves declined slightly during 1994, but, nevertheless, remained at a comfortable level of about 4 months of imports. Fiji's external debt position has improved further, to just about 16 percent of GDP, while the debt service ratio has also improved.

My Fijian authorities fully endorse the staff's Article IV report. In the recent 1995 budget statement, the Minister of Finance reaffirmed the commitment to implement policies in support of the country's reorientation to export-led growth initiated five years ago, as well as outlined a list of fundamental policies that must be followed to enable Fiji to sustain growth over the medium term. These policies would be reflected in measures to deregulate trade procedures affecting imports and exports, to strengthen the fiscal position, especially to control public sector wage increases and accelerate implementation of privatization policies which have been slower than what the authorities would like to see. They also recognize the need to revitalize private investment to lift the economy to its full potential. Although these represent difficult tasks, the expectations that economic growth could be maintained amidst a low level of inflation would give the authorities some maneuvering room to institute the necessary prerequisites and conditions, so that the pace of these significant reforms could be sustained over the next few years.

My Fijian authorities equally share the staff's concern on fiscal consolidation and expenditure control. As the staff rightly observed, the slippage in government deficits in 1993 and 1994 have been due mainly to the shortfall in revenue arising from the poor compliance to the two-year-old value-added tax. Nevertheless, the government's objective to return to a balanced budget was reaffirmed in the recent Budget statement. Toward this end, the authorities plan to reduce the fiscal deficit to a more sustainable level of 2.5 percent of GDP in 1995. In addition, the monetization of the government deficit will continue to be completely avoided as funding will be sourced mostly from non-inflationary private sector savings.

The Fijian government agrees with the staff on the urgent need for moderation in public sector wage increases. Bearing in mind that, because of the relative size of government, civil service pay awards tend to set the floor on industrywide awards in other sectors, the government is committed to addressing the wage issue to improve competitiveness. For example, it has succeeded in limiting the increase of the 1994 cost-of-living adjustment to less than 3 percent. Furthermore, in his 1995 budget address, the Minister of Finance proposed to change the system of wage determination in the public sector in order to allow the government to regain more control over total budgetary expenditure. The government also encouraged the private sector to respond to wage determination in line with productivity. More recently, the government has decided not to accept the recommendations of a foreign independent consultant who had recommended significant increases in salaries, the budgetary consequences of which would be have been inconsistent with the government's aim to reduce its size and improve operational efficiency.

Some progress has been achieved on the diversification front although Fiji's economy still depends heavily on the two traditional sectors of sugar and tourism. Manufacturing output, the growth of which stabilized after four years of rapid expansion, is now the third largest foreign exchange earner. This expansion was partly the result of incentives granted in earlier years. However, the authorities recognize that tax incentives alone are not sufficient. More important is the need to create a conducive environment for private sector investment. The authorities are, therefore, maintaining policies aimed at encouraging private investment through raising productivity and promoting trade. The measures to achieve this objective include a 2.5 percent reduction in the maximum tariff, phasing out of non-tariff trade barriers, and several tax reform measures including the removal of double taxation on dividends. However, considerable uncertainty remains regarding the possible impact of the new Uruguay Round on Fiji's preferential access to its major markets and its terms of trade. Another important step has been the government's acknowledgement that it has a role to play to resolve the land-lease issue which would have a significant impact on sugar production.

The high level of liquidity in the system is being continually addressed by weekly auctions of central bank bonds. In their management of liquidity, the monetary authorities are mindful of the need to maintain a low inflation rate to encourage private savings and investment, and to ensure that the country's external position remains comfortable. The authorities are, therefore, monitoring the situation closely and will tighten monetary conditions further in the event that indicators show a danger that domestic consumer demand is rising too rapidly and creating inflationary expectations.

Finally, the authorities wish to also assure the Board that the recent pressures in the foreign exchange market have completely subsided and would not impact on the government's plans to continue with its policies. In November, a crisis developed in the forex market following rumors of a possible devaluation of the Fiji dollar. The quick action by the Fijian authorities to stem the rather large outflows and speculative currency trades were quite successful in normalizing the markets. Measures taken included raising the short-term official interest rates--to 20-22 percent from 6-8 percent--and issue of press releases to quell the unfounded rumors--including the release of numbers on foreign exchange reserves to bolster confidence. The situation has since returned to normal. The international reserves of Fiji have now recovered to the level before the crisis.

Finally, let me, on behalf of my Fijian authorities, thank the staff for yet another fruitful Article IV discussion.

Mr. Petrie made the following statement:

I would like first to commend the staff for a well written report that clearly sets out the key issues.

Fiji's current economic situation is relatively favorable, with growth forecast at 3.4 percent for 1994, inflation down to 1.5 percent, unemployment at 6 percent, and the current account deficit at a manageable 1.3 percent of GDP. In part this is a result of the stabilization measures and structural reforms carried out since 1987.

However, we concur with the assessment in the staff report that Fiji's medium-term prospects do not look bright. In our view there are three key areas where the authorities need to take action. These are: reducing the budget deficit; taking actions that lead to an increase in investment; and sticking to a credible and consistent medium-term growth strategy.

While the authorities have announced their goal of achieving a balanced budget in recent years, the deficit has been stuck at over 3 percent of GDP since 1992. The key to reducing expenditures is to reform the public sector wage setting process, which at present does not allow the government to control its overall fiscal position. We welcome the announcement in the 1995 budget that the government still intends to change the wage determination process, and hope that the authorities can make early progress in this area. It will also be important to deliver on public enterprise reform, on which little progress has been made, and on ensuring an improvement in value-added tax collection and compliance.

The staff report points out that there has been little new investment in recent years, including in the key sugar and tourism sectors. This is likely to lead to a reduction in growth from current levels in the medium term. Getting the budget deficit down through controlling wages will obviously help in this regard, both by reducing crowding out of private investment, and by allowing a shift in government spending from current to capital expenditure.

There are other more specific actions required as well, however. For example, the uncertainty over renewal of land leases in the sugar industry is understandably impacting on investment. Given the importance of the sugar industry, the large number of leases coming up for renewal, and the level of past government involvement, it would seem necessary for the government to at least ensure there is a clear framework in place in which the parties can conduct their negotiations.

Finally, ensuring current growth rates are maintained will require that the authorities set out and stick to a clear and credible medium-term strategy.

In a number of areas, desirable policy targets have been set, but then not achieved. As noted earlier, this is true in the area of fiscal policy. It is also true of trade policy, and of structural reform more generally. In other areas, for example the minerals taxation regime, the authorities have yet to set out a clear policy. As noted by the staff, all this is having a negative effect on private sector confidence and investment, and could lead to increased pressure for a reversal of policy direction. Given the recent political history of Fiji it is even more important that the authorities build credibility and confidence in the overall thrust and consistency of policy. Experience elsewhere suggests that this is likely to be far more effective in generating increased high quality investment than any specific investment incentive schemes, which may well in fact be counterproductive.

I would like to conclude by wishing the authorities every success in their efforts.

Mr. Wang made the following statement:

The staff report, as well as Mrs. Cheong's comprehensive statement, give a clear picture of an economy facing the challenges of improving its supply perspective and pursuing appropriate fiscal adjustments. Fiji is rich in natural resources with the potential for a substantial pickup in private investment, essential for gaining significant employment opportunities and improving living standards. We note from Mrs. Cheong's opening statement that the authorities are "maintaining policies aimed at encouraging private investment through raising productivity and promoting trade."

Let me, therefore, make two remarks on the authorities' macroeconomic policy with respect to promoting private investment.

First, we agree with the staff that preventing the crowding out of private sector investment should be the key consideration of fiscal policy. In this respect, and also on the need to deal with supply fluctuations, we support the authorities' plan to achieve a medium-term balanced budget position. However, we are concerned that the lack of success in restraining government expenditure has increased private sector skepticism regarding the authorities' ability to achieve this goal. The authorities are encouraged to make further efforts in restraining government expenditure so as to create a stable macroeconomic environment to nurture the private sector.

Like the staff, we think it is necessary to address the budget structure. We welcome the 1995 budget and encourage the authorities to make every effort to achieve the announced budget targets. We also welcome the authorities' consideration of fundamental reform in the public sector wage-setting process.

Second, the authorities are encouraged to remain committed to structural deregulation which is the key to creating opportunities and inviting capital investment. We note the authorities' progress with wide-ranging market-oriented structural reforms, including trade liberalization and labor market reform. With regard to the land use policy and price distortions, some decisive action is required. Any ambiguity in the land use policy may not be conducive to promoting private investment.

Finally, let me say we agree with the staff analysis.

Mr. Prasad made the following statement:

I can endorse all the staff recommendations, particularly regarding the need for action on fiscal consolidation and the implications for the wage bill, and will not attempt to restate these concerns.

I would like to make a few comments on structural policies. As the staff report points out, this is an area where the authorities need to move quickly to consolidate the gains of the 1980s. The short term prospects for Fiji are still favorable; growth is expected to pick up to 3.4 percent, reflecting more tourist arrivals and higher sugar production. If we relate some aspects of structural reform to future growth prospects for Fiji, the paradox is that the present seems to belie the future; despite some major achievements and good potential, there are substantial risks of slippage. As the annex to the staff report on medium term prospects suggests, unless corrective steps are taken at this stage, the end of the decade could present a very different picture.

Consider, for example, trade. On the one hand, the authorities have moved substantially toward liberalization of trade in the last five years, reducing the general maximum tariff rates, removing quantitative restrictions (QR), and indicating their intention to become a full partner in the multilateral trading system. On the other, the failure to put in place an effective medium-term growth strategy could imply that the earlier protection systems are being dismantled, while the domestic system has not really become fully competitive. While one can understand and endorse the staff recommendation to not hesitate at this juncture in the trade liberalization program, this lacuna could explain why the authorities are hesitant to go through without further review of the experience to date with trade liberalization.

Important steps have been taken in the area of labor reform with the abolition of general wage guidelines, which has improved the labor climate. Admittedly, there have been delays, with frequent recourse to arbitration to settle disputes. But the labor climate can be considered reasonably conducive to assisting productivity increases, and is undoubtedly an asset. This would be offset by the following implications: to the extent that Government is still a leader in wage setting, the stance on the annual wage bill will also have a bearing on the private sector's wage decisions, and will form a part of its productivity or profitability calculations. This is therefore an equally important reason, beyond the deficit, for the Government to cap the wage bill and move out of the process of wage determination.

The loss of skilled workers through emigration is a sensitive internal issue, but what is the impact on productivity? Are the steps that have been taken for training expected to substitute for this producing results? Following up on its 1993 Country Report, does the World Bank contemplate a role in this?

Also, uncertainty over the land use policy will definitely retard investments in agriculture. Unless a transparent system can be installed early, in the medium-term a decline in production is likely. Already, sugar production and sugar export as a percentage of total exports has declined. Could this be a factor?

Finally, I wonder why the authorities have not accorded more priority to a medium-term tourism expansion strategy. Apart from the short-term implications for growth and employment, expansion of tourism facilities would be a substantial enhancement of earning capability, as brought out in staff reports.

Clearly, the authorities need to urgently shift their attention to a viable medium term growth strategy. Fiji has had some good years, and has been comfortable with the trade preferences available for its main exports. We note from Mrs. Cheong's statement that diversification is already starting to take place, but much could change now in the new trading environment, and the Fijian economy needs to both expand and diversify if it is to compete. A clear and predictable medium-term framework would greatly improve investor confidence.

Ms. Glennerster said that, as other speakers had commented, the medium-term outlook was not encouraging. Sluggish economic growth was likely to persist, given the low private sector investment and falling savings. As Mr. Petrie had observed, there were several reasons for the disappointing performance, including the problems of land tenure, wage setting, and overshooting of fiscal targets.

An additional reason was the damaging effect of an uncertain structural reform process, which was stalling owing to pressure from sectional interests, Ms. Glennerster continued. To improve its medium-term performance, Fiji needed to accelerate the pace of structural reform and fiscal consolidation, and harness the full resources of its population--in particular, by addressing the emigration of skilled labor overseas.

A fixed exchange rate might be useful in the short run to lock in the recent reduction in inflation, Ms. Glennerster remarked. However, from a medium-term perspective, the economy was likely to face a number of shocks, notably from the reduction in trade preferences in the sugar and the garment sectors. Changes in industrial structure would be needed to protect the external balance, and possibly a low real exchange rate would be necessary. The first-best solution would be greater flexibility of wages, without which Fiji's attempt to keep the currency at its current level might be jeopardized, compounding the country's problems.

Mr. Rigász said that the authorities were to be commended for the stability and diversification of the economy achieved in recent years. Given the relatively favorable short-term economic prospects, the Government could aggressively implement policies to deal with the country's principal challenges--to sustain growth over the medium term, with a low level of inflation. Mrs. Cheong had assured the Board that the authorities recognized the potential threats to long-run economic development, and were committed to maintaining the pace of the reforms over the succeeding few years. In that regard, while implementing the 1995 budget, the Government should avoid further slippages in public finance and make significant improvements in the structural budgetary position, if business confidence was not to be eroded further. Given the repeated failures to adhere to fiscal targets in 1993 and 1994, the envisaged containment of the fiscal deficit to 2.5 percent of GDP in 1995 seemed to be too optimistic. The attainment of that target would probably depend on the ability of the Government to regain control over total budgetary expenditures.

With regard to the remaining distortions in the economy, Mr. Rigász observed, the recent decline in inflation should be used to reduce the number of items at the wholesale level covered by price controls, and to eliminate some of the price controls at the retail level--which had accounted for 37 percent of the consumer price index basket.

He wondered whether the Olympic games in Sydney in the year 2000 were likely to lead to an increase in foreign private investment inflows into Fiji, Mr. Rigász concluded.

Mr. Huisman made the following statement:

> I agree to almost everything that is written in the staff appraisal. Unlike Ms. Glennerster, however, I have some difficulties with the recommendations concerning the exchange rate policy in the longer-term, in particular that given the expected

weakening of the external position owing to the GATT agreement--erosion of trade preferences--"consideration may need to be given to an adjustment in the exchange rate". In itself we welcome the fact that the fundamental issue of the direction of exchange rate policy has been taken up in the paper; sometimes this is not done at all in staff documents. In the specific case of Fiji, however, I wonder whether the most appropriate policy recommendation has been given. It may be that the consequences of GATT are very substantial, but I doubt whether a devaluation is the right answer. Would it not be more feasible to take adjustment measures in the real sector in light of the foreseen permanent, and not temporary, external shock, that is, the impact of GATT and other temporary shocks? The staff could perhaps have pointed more explicitly at the policy actions that are required to maintain the peg in the longer term. Besides being much more determinant with fiscal policy, a lot remains to be done for the authorities in the structural field. I only mention that the government still controls the prices of a large number of consumer products. In general, it is essential that governments of small, island economies stick to a consistent and transparent exchange rate policy whatever the precise regime, and that they show their determination by pursuing supportive underlying macroeconomic policies. In this respect, I think it is encouraging that the Fijian authorities recently reacted promptly to sudden exchange rate pressures by raising interest rates and issuing press releases to calm the rumors.

The staff representative from the South Asia and the Pacific Department said that, given the current circumstances, the Reserve Bank of Fiji had taken the correct decision to maintain an exchange rate peg. At the moment, the external position of the country was comfortable: reserves were relatively high, external debt was low, and the only adjustments needed were on the structural and fiscal policy fronts. In that context, the staff believed firmly that any efforts to push growth through the exchange rate policy would not be productive, given, in particular, the ongoing rigidities in the labor market. It would be essential to consolidate the positive inflation performance that appeared to be emerging, and particularly not to endanger it with renewed wage pressures.

From a medium-term perspective, given Fiji's small open economy and vulnerability to shocks, and taking into account the specific risks associated with the erosion of trade preferences, it was possible that a more flexible exchange rate regime could facilitate the kind of real adjustments that would be necessary over the remainder of the decade, the staff representative observed. However, many conditions needed to be fulfilled before that conclusion could be reached. Progress had to be made on the structural front. It was also necessary to maintain financial stability over the succeeding few years before considering the adoption of a more flexible exchange rate regime.

As regards the impact of emigration on labor force skills, the authorities were aware that the loss of a large number of trained and experienced people who had left the country over the previous seven years could not be made up very quickly, the staff representative explained. Considerable emphasis had been given to education and training, and some recourse had also been made to hiring foreign experts, although the latter was not viewed as a long-term solution.

The Olympic games in Australia in the year 2000 might have an impact on tourism in Fiji toward the end of the decade, the staff representative concluded. However, the structural measures noted in the staff report were the primary considerations for attracting the domestic and foreign investment that would be needed for sustainable economic growth over the medium term.

Mrs. Cheong thanked the Executive Directors for their constructive comments and suggestions. The Fijian authorities had made considerable efforts in implementing stabilization policies to ensure a satisfactory overall economic performance. Special attention had been devoted to specific areas on which Directors had commented during the 1993 Article IV consultation discussions--for example, the implications of the rising wage bill on the fiscal deficit. However, much more needed to be done in that area. Although the Government had rejected the proposal for wage increases in the public sector, the issue of wage arbitration--raised by Mr. Petrie--needed to be resolved. Measures to ensure that budgetary targets were met and were maintained in a consistent manner should also be undertaken. The Government had promised to assist in the modalities to resolve the land lease problem. The authorities would be informed about the Board's concern that the issue be resolved at an early date.

The authorities had recognized the need for a coherent trade policy, particularly in view of the possible fall in prices of its sugar exports that could arise from the new multilateral trade arrangements, Mrs. Cheong observed. As that could constrain the country's external position, the authorities had commissioned a study on the implications of the removal of preferential treatment of Fijian exports. It was hoped that the study would provide new directions for the Fijian economy to develop. In that context, the authorities had recognized the importance of measures to diversify and expand the manufacturing sector, and the need to take measures to increase private investment. Within the manufacturing sector, the authorities would take measures to diversify exports--especially garments--in order to cushion the economy from external developments.

She would convey to the authorities the fact that many Directors had emphasized the need for a more coherent medium-term growth strategy, in which further structural adjustments might be necessary across-the-board, Mrs. Cheong concluded.

The Acting Chairman made the following summing up:

Executive Directors noted that, after the weather-related slowdown in 1993, economic growth had picked up in 1994--an outcome that had been achieved with relative price stability, while maintaining gross international reserves at a comfortable level, and reducing the stock of external debt. At the same time, Directors observed that investor confidence remained weak, largely as a result of past policy slippages. Directors, therefore, believed that the authorities should attach high priority to three objectives: reducing the budget deficit, raising investment, and the pursuit of a credible medium-term growth strategy.

With regard to fiscal policy, Directors noted that little progress had been made in reducing the deficit in recent years. They observed that most of the reduction in the overall deficit in the 1994 budget would be attributable to the pickup in economic growth, rather than any underlying improvement in the budgetary position.

It was emphasized that fiscal consolidation would require a significant improvement in expenditure control, most importantly in the wage bill. Failure to restrain government wages would not only have a direct impact on the budget deficit, but would also put upward pressure on wages throughout the economy, at a time when low inflation needed to be locked in. On the revenue side, Directors pointed to disappointing value-added tax collections as the main risk to the budget, and encouraged the authorities to continue their efforts to improve value-added tax compliance and collections.

Directors considered that the conduct of monetary policy had been broadly appropriate. With respect to exchange rate policy, Directors believed that the current exchange rate policy remained appropriate, provided that it would be supported by an improved fiscal position, public sector wage restraint, and an appropriate monetary policy. However, in view of Fiji's vulnerability to external shocks, it was also emphasized that Fiji needed to keep the exchange rate policy under review.

Directors noted that significant progress had been achieved over the past several years in the area of trade liberalization, but urged the authorities to reduce uncertainty in trade policy by seeing to it that their phased approach to trade deregulation is completed. Directors also recommended that the scope and discretionary elements of fiscal incentive schemes be reduced, as another contribution the Government could make to minimizing uncertainties that might discourage investment. They also encouraged the authorities to take advantage of the low inflation environment to reduce the coverage of price controls, and to work expeditiously toward the establishment of a framework for renegotiation of land leases. These measures were most important, in the view of Directors, in order to strengthen Fiji's medium-term growth and employment-creation potential.

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

4. MEXICO - REPORT BY STAFF

The Director of the Western Hemisphere Department said that Executive Directors had received the communication of Mr. Guzmán-Calafell dated December 20, 1994, which described the recent exchange rate measures taken in Mexico. The Mexican exchange regime had consisted of a band within which the exchange rate was allowed to float. On the previous day, the authorities had announced a 15 percent adjustment of the upper end--the most depreciated side--of the band. Thus, in the current system, the band had been widened from 15 to 31 percent, and the exchange rate was allowed to float within that wide band. The measure was intended to give the Bank of Mexico greater room to maneuver, in the presence of the political uncertainties that had arisen in recent days. Other policies of the Government, including fiscal policy and the goals of the Government as recently announced, remained unchanged.

A few days earlier, the authorities had announced a 7 percent increase in minimum wages, effective January 1, 1995, the Director commented. That increase consisted of two parts: a 4 percent allowance for projected inflation, and 3 percent for productivity increases. The wage settlement had been reached in the context of the agreement with business and labor, under the pact for welfare, stability and growth, that had been agreed in September 1994. The authorities had confirmed that they would honor the 7 percent wage increase.

Before the change in the exchange regime on December 19, the peso had reached the most depreciated end of the band, and the Bank of Mexico had had to intervene in order to support the rate, the Director continued. After the widening of the band on December 20, the peso had depreciated by about 13 percent in effective terms. Since the beginning of 1994, the peso had depreciated vis-à-vis the dollar by 26 percent in nominal terms--within the existing regime, by 12 percent up to December 19, plus the depreciation of December 20. During the first ten months of 1994, the real effective exchange rate had depreciated by about 8.5 percent, and a rough calculation had suggested that the depreciation for the year, in real effective terms, would be of the order of 15 to 20 percent; that calculation did not consider the weight of the different currencies in Mexico's trade.

In local currency terms, the stock exchange had declined by 4 percent on December 19, had risen by about 2 percent on December 20, and eventually had lost that gain on the morning of December 21, the Director explained. The interest rates on dollar-denominated instruments had risen on December 20 by 88 basis points, to a level of 8.28 percent. Regarding peso-denominated instruments, in the case of the 28-day Cetes--the most commonly traded treasury bond--the interest rate had risen by 225 basis points, and consequently, the structure of interest rates had changed. Interest rates on instruments with long-term maturities had increased much less than on those with short-term maturities. For six month treasury notes, the interest rate had risen by about 115 basis points.

There were some favorable trends in Mexico, the Director observed. Real GDP growth, which had slowed to 0.4 percent in 1993, was projected to rise to about 3 percent in 1994. The rate of inflation, which had been of the order of 30 percent in the early 1990s, had declined to 8 percent in 1993, and was expected to fall to 7 percent in 1994. While the devaluation might affect that estimate to some extent, the staff would not expect the impact to be large. The public finances had remained strong, and the primary surplus was expected to be 2.6 percent of GDP in 1994. According to the estimates released by the authorities, which the staff believed were reasonable, an overall balanced budget could be anticipated for the year as a whole.

The external current account deficit was expected to widen by about 1 percentage point of GDP in 1994, but that needed to be considered in the context of a rapid growth in exports, the Director commented. The U.S. dollar value of Mexico's manufacturing exports for the first nine months of 1994 had increased by 21 percent compared to the same period of 1993, but imports also had been growing rapidly.

Ms. Lissakers asked what the growth projections for 1995 were, and the rate of increase in imports for the first nine months of 1994.

The Director of the Western Hemisphere Department responded that the authorities expected a 4 percent increase in real GDP, which the staff considered reasonable. Imports had increased by 21 percent in dollar terms in 1994, but with the new exchange rate, the rate of increase in imports would slow considerably. The projected inflation rate of 4 percent in 1995 needed to be re-examined. In that context, it was encouraging to note that the wage agreement would be maintained.

Ms. Lissakers said that she wondered about developments in foreign financial inflows, both short-term and direct investments. She wondered whether there had been a change in the pattern at the end of the year, as compared with the beginning of 1994.

The Director of the Western Hemisphere Department responded that, given the tumultuous nature of the year--an insurgency at the beginning of the year and the assassination of candidate Colosio--it was hard to draw conclusions about the pattern of financial flows, but those events had affected short-term financial flows. Direct investment, however, had been stable.

Mr. Guzmán-Calafell said that, during the period January-September 1994, the capital account showed a net inflow of $14.3 billion. Inflows of foreign investment had been $17.1 billion, including $5.8 billion of direct investment and $11.3 billion of portfolio investment. Those figures showed a substantial increase in direct investment flows in comparison with the same period in 1993.

The Bank of Mexico and the Ministry of Finance would issue a press communiqué shortly, Mr. Guzmán-Calafell remarked. It would state that pressures in the exchange rate market had escalated as a result of a large current account deficit in 1994 and a perception of a similar deficit in 1995, in the context of a declining supply of loanable funds in international financial markets, and because of the threats to social peace by the Zapatista army, which had generated a climate of uncertainty, preventing a healthy economic recovery.

No use had been made of the Stabilization Exchange Facilities established by Mexico with the financial authorities of the United States and Canada, Mr. Guzmán-Calafell added. The new exchange rate regime was consistent with low inflation and sustainable economic growth. Similar results had been observed in several EMU countries that decided to modify their exchange regime under comparable conditions to those faced by Mexico.

The exchange rate adjustment had taken place with the other elements of the "Pacto" unchanged, Mr. Guzmán-Calafell observed. The wage policy agreement had remained unaltered. In line with that agreement, the National Commission for Minimum Wages had agreed on December 19 to an increase in the minimum wage of 4 percent, based on expected inflation, plus an additional increase of 3 percent, based on the expected national average increase in productivity.

The impact of the exchange rate adjustment on the public finances was virtually neutral, given that the possible increase in the service of foreign debt and Tesobonos would be compensated by the additional revenues in pesos derived from oil exports and import tariffs, Mr. Guzmán-Calafell commented. The public finances would be further supported by privatization programs of ports, airports, and other public enterprises in the industrial and services sectors; the auction of rights to use the radio spectrum; and the securitization of the future income flows produced by the Mexico City-Queretaro and Mexico City-Puebla toll highways.

Interest rates had been increased in order to stabilize the foreign exchange rate in the short run, Mr. Guzmán-Calafell said. The Director of the Western Hemisphere Department had already mentioned the increases that had been observed in Cetes rates. The central bank had been acting aggressively in the short-term money market, and overnight interest rates had increased by about 10 percentage points. The fiscal, monetary, and wage policies contained in the "Pacto," along with the current year's real exchange rate depreciation of more than 20 percent--28 percent in nominal terms--should produce a correction in the current account deficit.

The growth rate of the credit to be granted by development banks would be reduced substantially, so as to reinforce the corrective impact on the current account deficit of the measures to be implemented, Mr. Guzmán-Calafell continued. The new exchange rate arrangement, along with a consistent macroeconomic framework and flexible interest rates, should attract the required foreign capital to cover the smaller current account deficit.

Current regulations established limits on the open foreign exchange positions that financial intermediaries might take, Mr. Guzmán-Calafell concluded. Thus, it was to be expected that the peso depreciation of December 20 would not have a significant effect on financial intermediaries' health.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/112 (12/19/94) and EBM/94/113 (12/21/94).

5. RELATIONS WITH WTO - ARRANGEMENTS GOVERNING FUND PARTICIPATION IN CONSULTATIONS WITH THE COMMITTEE ON BALANCE OF PAYMENTS RESTRICTIONS

The Executive Board approves the proposal by the Managing Director with regard to participation in consultations with the WTO Committee on Balance of Payments Restrictions as set forth in EBD/94/198 (12/16/94).

Decision No. 10871-(94/113), adopted
December 21, 1994

6. AUDIT COMMITTEE, FY 1995 - COMPOSITION AND NOMINATIONS

The Executive Board approves the Managing Director's recommendation that Botswana, Fiji, and Germany be invited to submit nominations of persons to serve on the External Audit Committee for financial year 1995 and confirms the nominations set forth in EBAP/94/104 (12/14/94).

Adopted December 19, 1994

7. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the reconstitution of the membership of the Executive Board standing committees as proposed by the Managing Director in EBD/94/15 (12/15/94).

Adopted December 20, 1994

8. PENSION COMMITTEE - NOMINATIONS

The Executive Board approves the election of the Executive Directors nominated to serve as members of the Pension Committee for the term ending October 31, 1996, as set forth in EBAP/94/105 (12/15/94).

Adopted December 20, 1994

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/94/198 (12/16/94) is approved.

APPROVAL: November 2, 1995

LEO VAN HOUTVEN
Secretary