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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/29

10:00 a.m., April 1, 1994

Contents

## Executive Board Attendance

R. D. Erb, Acting Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| M. Al-Jasser | A. A. Al-Tuwaijri |
| M.-A. Autheman | M. Sirat |
| | D. Desruelle, Temporary |
| | A. Törnqvist, Temporary |
| H. Evans | J. Dorrington |
| H. Fukui | T. Oya, Temporary |
| K. P. Geethakrishnan | L. E. N. Fernando |
| J. E. Ismael | |
| D. Kaeser | C. Imashev, Temporary |
| A. Kafka | A. Calderón |
| K. G. Kagalovsky | B. M. Lvin, Temporary |
| | V. Y. Verjbitski, Temporary |
| W. Kiekens | J. Prader |
| | J. Hamilius, Temporary |
| | J. C. Martinez Oliva, Temporary |
| | S. Vori, Temporary |
| | B. S. Newman |
| | J. M. Abbott, Temporary |
| | J. B. Wire, Temporary |
| R. Marino | G. Torres |
| A. Mirakhor | H. Golriz, Temporary |
| | B. Dlamini |
| | Y. Patel, Temporary |
| G. A. Posthumus | J. W. van der Kaiij, Temporary |
| | N. Toé, Temporary |
| | J.-C. Obame, Temporary |
| S. Schoenberg | E. Wagenhoefer |
| A. S. Shaalan | S. K. Fayyad, Temporary |
| D. E. Smee | G. F. Murphy |
| | K. G. Langdon, Temporary |
| E. L. Waterman | |
| Zhang M. | Wei B. |
| | Wang Y., Temporary |
| A. G. Zoccali | A. Jiménez de Lucio |

L. Van Houtven, Secretary and Counsellor
T. S. Walter, Assistant

Also Present

IBRD: J. Shirazi, South Asia Regional Office; M. Noel, Europe and Central Asia Regional Office. Central Asia Department: H. Neiss, Director; B. B. Aghevli, Deputy Director; D. J. Goldsbrough, Y. Horiguchi, L. E. Leruth, K. E. Parker, B. R. S. Rajcoomar, S. B. Schwartz. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; S. B. Brown, R. F. Krieger, C. J. McNeilly. External Relations Department: S. J. Anjaria, Director; G. Hacche. Fiscal Affairs Department: C. Van Rijckeghem. Legal Department: R. H. Munzberg, Deputy General Counsel; P. De Boeck, J. L. Hagan, Jr. Middle Eastern Department: A. C. A. R. Furtado. Monetary and Exchange Affairs Department: C. Cottarelli. P. Dattels. Policy Development and Review Department: T. Leddy, Deputy Director; M. Allen, M. L. Agarwal, D. Andrews, A. R. Boote, M. Fisher, P. H. Mathieu, R. Moalla-Fettini, C. R. Shiells, A. Singh, J. K. Wakeman-Linn. Secretary's Department: K. S. Friedman, A. Mountford. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; J. E. Blalock, B. R. Burton, J. C. Corr, Z. Farhadian-Lorie, G. M. Fitzpatrick, B. E. Keuppens, F. M. Meek, O. Roncesvalles, R. Thorne, B. C. Yuen. Western Hemisphere Department: A. S. Linde. Office of the Managing Director - Office of Internal Audit and Review: M. Caiola, Director; E. C. Lichner. Advisors to Executive Directors: J. O. Aderibigbe, M. A. Ahmed, G. M. Blome, A. Chang Fong, J. Jamnik, A. Raza, J. R. Suárez. Assistants to Executive Directors: S. E. Al-Huseini, S. Arifin, M. C. B. Arraes, D. A. Barr, T. Berrihun, R. Bessone Basto, P. I. Botoucharov, M. A. Brettschneider, J. M. Burdiel, A. Cathcart, J. A. Costa, C. D. Cuong, G. El-Masry, J. C. Estrella, M. Fein, R. Ferrillo, L. Fontaine, A. Galicia, O. Himani, G. H. Huisman, T. Kanada, E. Kouprianova, G. J. Matthews, S. Narube, S. del C. Olgiati, J. Pesola, H. Petana, C. F. Pillath, R. K. W. Powell, N. Prasad, S. K. Regmi, D. Saha, T. Sitorus, A. Viirg.

1. EXECUTIVE DIRECTOR

The Managing Director welcomed Mr. Kiekens, Executive Director for Austria, Belarus, Belgium, Czech Republic, Hungary, Kazakhstan, Luxembourg, Slovak Republic, and Turkey.

2. INDIA - 1994 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1994 Article IV consultation with India (EBS/94/16, 2/7/94; and Sup. 1, 3/21/94). They also had before them a background paper (SM/94/48, 2/25/94).

The Deputy Director of the Central Asia Department made the following statement:

> The following information has become available since the supplement to the staff report for the 1994 Article IV consultation was issued.
>
> On March 30, 1994, the authorities announced some further trade liberalization measures. The scope of the existing special import license scheme has been expanded to cover a number of additional import items and a wider category of eligible exporters. Under the scheme, some exporters receive tradable licenses that can be used for the importation of selected items--mainly consumer goods--that are otherwise banned; the value of the licenses is generally equivalent to 5-10 percent of export earnings. Preliminary estimates suggest that, under the expanded scheme, the total value of licenses utilized could more than double, to about $1/2 billion, in 1994/95. In addition, a number of items--mainly electronic components--have been removed from the negative list and are now freely importable through open general licenses. In the staff's view, these measures represent a welcome further liberalization of India's trade regime but fall well short of eliminating the highly distortionary quantitative restrictions on consumer goods imports.
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> The authorities recently notified the Fund officially of their decision to effect all repurchases falling due during the 1994/95 fiscal year--April 1994-March 1995--amounting to SDR 805.1 million, on April 22, 1994. Accordingly, based on existing interest rates, charges for the year are projected to decline to about SDR 173 million.
>
> The authorities have indicated that they expect soon to accept the obligations of Article VIII, Sections 2, 3, and 4.

Mr. Geethakrishnan made the following statement:

The task of restructuring an economy, especially an economy faced with a severe external payments crisis, is at best a complex and time-consuming process. This is the task that India had embarked upon in June 1991. The Board noted in June of last year, while reviewing the stand-by arrangement, that within a period of two years the Indian authorities had successfully managed the critical balance of payments position, brought inflation under control, and embarked on a path of sustained economic growth through a series of bold stabilization measures and structural reforms in the spheres of trade, industry, and the financial and public sectors aimed at increasing efficiency and productivity and integrating the Indian economy with the global economy. Most Executive Directors, at that stage, had underlined the need for further accelerating the process of macroeconomic stabilization and structural reforms.

I am happy to report that since then India has progressed further on this path. This is evident from the two papers circulated by the staff. India's balance of payments position has improved dramatically in the past ten months as a result of the reform of exchange rate and trade policies. Exports have increased by 21 percent in U.S. dollar terms in the first ten months of 1993/94, compared to a decline of 3 percent in 1991/92 and a rise of only 2 percent in 1992/93. Consequently, the current account deficit in 1993/94 is now projected to be less than 0.5 percent of GDP, compared with over 3 percent in 1991/92 and 2 percent in 1992/93. The latest figures place the foreign exchange reserves excluding gold at $14.5 billion, representing seven months' import requirements. This development has not only given my authorities the confidence to consider prepayment of some of the loans taken earlier, but also to take steps to move to Article VIII status soon.

Inflation has remained in single digits, but with the slippage in fiscal discipline and surge in capital inflows, it could come under pressure again. However, in view of the record food grain stock--23 million tons--and the steps taken to further activate the large unutilized industrial capacity, the Indian Government is confident of containing inflationary pressures within acceptable limits. It is this combination of a comfortable balance of payments position and the expectation of keeping inflation within manageable levels that has enabled my authorities in the recent budget to focus attention on increasing investment and employment opportunities and thereby speed up the growth process.

The slow growth of industrial production in 1993/94 of only 1.9 percent has been a matter of great concern, and the existence

of sizable idle industrial capacity and low investment levels, especially in the capital goods sector, has to be addressed now for a meaningful economic recovery to take place. The slow pickup in industrial production last year seriously hurt revenue, and a strong growth impetus was therefore needed to contain further fiscal pressures. The budget proposals primarily aim at a turnaround in investment and industrial production, while the need for fiscal correction is recognized and shall be addressed through a package of tax reform measures. These include simplifying and rationalizing the tax structure, widening the tax base, adding buoyancy to revenues by shifting to ad valorem duties, cutting down exemptions, and improving tax administration.

It is hoped that better compliance and collection of taxes, coupled with restraint on government spending, will yield the required degree of fiscal correction. As the Finance Minister said in his budget speech, "[a]lthough one cannot be dogmatic in these matters, my considered view is that the risks involved in the course of action I have proposed do not cross the limits of prudence." Any other strategy would perhaps be unproductive in the Indian situation today, which is characterized by a sizable unutilized industrial capacity, record foodstocks, and comfortable foreign exchange reserves. With the various measures envisaged in the budget proposals, GDP growth is expected to pick up to 5-6 percent in the coming year, compared to less than 4 percent in 1993/94. The Board will recall that this chair has often emphasized that macroeconomic consolidation and structural reform could result, in the initial stages, in a fall in the growth of GDP, as well as of employment opportunities, and that it would therefore be necessary two to three years down the line to suitably alter the mix of policies in order to focus attention on increasing employment opportunities and growth. This is the best way to ensure sociopolitical acceptability and sustain the reform process itself.

The fiscal deficit in 1993/94 overshot the initial estimate and is now expected to rise to 7.3 percent of GDP. In 1994/95, however, it is targeted to fall to 6 percent. This does appear somewhat high, but let me clarify that this is not due to a splurge in nondevelopment and nonessential items of expenditure. In fact, the total nonplan expenditure, excluding interest payments, is expected to decrease to 6.5 percent of GDP in 1994/95, compared to 8.4 percent in 1991/92. It may also be borne in mind that this category of expenditure includes items such as central government staff salaries, defense, and subsidies, as well as transfers to States, in all of which a sharp reduction is not feasible. The budget for 1994/95 has a provision of Rs 40 billion each for fertilizer and food subsidies, but this amounts to just about 1 percent of GDP, compared to 1.9 percent in 1991/92. The provision for defense in real terms will remain static at

2.5 percent of GDP. In this context, I may also point out that the share of defense expenditure in GDP has been reduced by more than 25 percent over the past six years.

The main reasons for the relatively large fiscal deficit are an increasing interest expenditure, a sharp step-up in plan expenditure, and a steady decline in tax revenue as a proportion of GDP. Interest expenditures have risen, owing to the shift--as a part of the reform process--to an increasing proportion of government borrowing from sources at market-related interest rates and reduced reliance on concessional support from the Reserve Bank of India. In the latest budget, the Government has announced its decision to phase out altogether over the next three years its access to concessional treasury bills. The planned expenditure category covers, inter alia, investment in infrastructure, social overheads, poverty alleviation, and rural development programs. These outlays have been increased in the revised estimates for 1993/94 and the budget for 1994/95 by about Rs 100 billion over the outlay in 1992/93. This sharp increase was necessary to provide a social safety net, increase speedily employment opportunities, and give a boost to growth. As regards tax revenue flows, the Board is aware of the Government's actions to reduce the high levels of tariffs and indirect taxes. With the contraction in imports that took place in 1991/92 still to be made good and the sharp drop in industrial growth, the reduction in tariff rates naturally resulted in a fall in tax revenues from 10.84 percent of GDP in 1991/92 to less than 9 percent in 1994/95. It is only with an increase in imports and a recovery in industrial activity that tax revenues can be expected to rise sharply again. The budget proposals for 1994/95 aim precisely at this.

As far as structural reforms are concerned, the staff papers give a very good overview of the actions taken, as well as those contemplated, in the recent budget. As the supplementary report itself states, the centerpiece of the budget is the tax reform. I have already highlighted the broad thrust of the efforts in this direction in the earlier part of my statement, and substantial progress is expected to be made this year. Particular attention should also be given to areas such as the introduction of a value-added tax, where progress thus far has been slow.

The staff papers have highlighted key reform measures in other areas as well. I would like to add only that, reform being a continuous process, the numerous measures taken from time to time add up to much more than the key action points to which greater importance is sometimes attached. To illustrate, in financial sector reform, apart from substantial reductions in the statutory liquidity ratio--from 38.5 percent to 31.75 percent--and the cash reserve ratio--from 15 percent to 14 percent--the

reduction in lending rates by 5 percentage points in the past two years, the prescription of capital-adequacy norms, and the strengthening of the equity base of the banks, which enabled entry of the private sector, including foreign banks, several other important changes were effected.

First, over a three-year period, central government access to ad hoc treasury bills was phased out. Second, a board for financial supervision was set up by the Reserve Bank of India. Third, banks were allowed to directly undertake leasing, factoring, and hire purchase business. Fourth, the 1949 Banking Regulation Act was amended by raising the ceiling of voting rights for a shareholder from 1 percent to up to 10 percent and permitting banks to have nonexecutive chairmen. Fifth, the National Bank for Agriculture and Rural Development was allowed to enter into memoranda of understanding with state and district cooperative banks for implementing state-specific development action plans. Sixth, regional rural banks were restructured to give them greater flexibility in lending operations, to improve their viability. Finally, on the capital markets side, a model national stock exchange with screen-based trading, which is expected to begin operation by the middle of the year, and a depository system of scripless lending--another milestone--were established.

The list of actions taken is long. My intention is only to highlight that the reform process is being constantly deepened, resulting in considerable systemic gains. The productivity and efficiency of the economy is also being improved through a more competitive environment in all spheres of activity. Civil aviation, petrochemicals, oil exploration and refining, and power generation are some of the key sectors in which a large number of private and joint ventures are coming up. As the reform process continues and the confidence of foreign investors is built up, India is fast becoming an attractive destination for investment. Foreign investment, both direct and portfolio, has grown over the past three years from $200 million in 1991/92 to $437 million in 1992/93, and now to more than $3 billion in 1993/94, as of February 1994. The figures speak for themselves.

Before I conclude, I would like to thank the staff for its excellent papers. As I mentioned last June, the dialogue between the staff and my authorities has continued to be highly constructive, its assessment and observations balanced, and its suggestions pragmatic and practical. If at all--and, I repeat, if at all--there is any difference in the perceptions between the staff and my authorities, it is on the sequencing and timing of the implementation of the various elements in the reform package, rather than on the package itself.

Mr. Shaalan made the following statement:

India has no doubt come a long way since it sought Fund financial assistance in 1991. By one measure, namely, the level of foreign exchange reserves, India has done exceptionally well, if one considers the buildup in reserves to the current comfortable level--equivalent to seven months of imports--from the perilously low level in 1991. The fact that India will this month be effecting early repurchases of obligations to the Fund serves to underscore the dramatic extent of a most impressive turnaround, which in no small measure is a reflection of the restored confidence in the prospects of the economy.

There were other successes on the adjustment front over the period 1991-93. These include a sizable reduction in the central and public sector fiscal deficits, a substantial reduction in inflation, and a rebound in the growth of exports. Moreover, fundamental reforms were launched during the period, with the aim of enhancing the market orientation of the economy and of improving its supply responsiveness.

Having said this, I do not believe that there can be much disagreement that, to quote from the staff report, "much remains to be done to ensure that the recent stabilization gains are not reversed and that India moves onto a more dynamic growth path that can be sustained over the longer term."

This assertion takes on added significance in view of the ground lost on the fiscal front in 1993/94, with both deficits of the Central Government and the overall public sector exceeding the budget targets and last year's outturns. Moreover, beginning in mid-1993, performance on the inflation front began to deteriorate as well.

Insofar as the fiscal situation is concerned, we note that about half of the slippage stemmed from a revenue shortfall. The shortfall reflected a slower than projected growth of imports and industrial production, as well as higher than expected revenue losses associated with the tariff reform. On the expenditure side, the fiscal deterioration stemmed mainly from failure to adjust administered prices of food and fertilizers, faster implementation of foreign-financed projects, and increased outlays on employment-creating programs. I mention this partly to indicate that we are not unsympathetic to the view that a mid-course correction for fiscal overshooting is not easy to undertake against the backdrop of continuing slack in important parts of the economy and a degree of comfort deriving from a relatively strong external position. This said, however--and as I indicated earlier--inflation began to accelerate in mid-1993. Moreover, and perhaps more important, the recent unexpected strength of India's

external position partly reflects, on the current account side, a weak demand for investment and imports. On the capital account side, it certainly cannot be ruled out that, through their effect on interest rates, fiscal pressures have tended to attract speculative capital inflows. Therefore, an early return to the medium-term path of fiscal consolidation is necessary.

The 1994/95 budget proposals represent an important step toward that goal, and we believe that the introduction earlier this year of a number of important price measures in difficult political circumstances underscore the authorities' resolve to re-establish a path toward fiscal consolidation. Nevertheless, the question remains as to whether the 1994/95 budget proposals signal a convincing enough return to that path. The staff does not believe that they do, while the authorities maintain that a stronger degree of fiscal correction would not be conducive to a pickup in economic growth, and could entail a postponement of much-needed reductions in import tariffs. Although, here again, I have some sympathy with the authorities' views, I believe that the need for fiscal policy to play a key role in neutralizing the impact of capital inflows on domestic demand argues for a vigorous pursuit of fiscal tightening. I therefore hope that this will factor importantly in the authorities' formulation of their revised medium-term fiscal targets.

The staff has provided in the supplement to the report a succinct yet highly insightful analysis of the policy implications of the surge in capital inflows in India. The scope of the challenges for macroeconomic management at this juncture is underscored by the fact that through January 1994, the inflows were more than five times their level for all of 1992-93. I agree with the thrust of the staff's analysis, and I would, in particular, agree that the one-way bet implied by a stable nominal exchange rate and high domestic interest rates may be broken by allowing some nominal appreciation. As noted by the staff, notwithstanding its adverse implications for export competitiveness, a nominal appreciation would allow the expected real appreciation to occur without higher inflation. Let me add that recent steps to lower interest rates should contribute to the adjustment in the face of the capital inflows, both directly and by contributing to a turnaround in investment, which would translate into higher imports.

Mr. Mirakhor made the following statement:

The striking economic turnaround that India has achieved since 1991 has been widely acclaimed by this Board. The authorities have earned well-deserved praise for their decisive and timely policy actions, which have brought India to the threshold of realizing its considerable economic potential. This

chair has been pleased to echo those sentiments and has strongly endorsed the breadth and range of India's adjustment and reform program.

The excellent staff papers, as well as Mr. Geethakrishnan's helpful statement, detail the developments in the Indian economy in 1993, and I will not repeat them here. Suffice to say that the economy's performance in the external sector in 1993/94 surpassed all expectations. At the same time, the fiscal position deteriorated, giving rise to concerns that the country might risk losing the hard-won gains of the past three years. The staff made a case for reinvigorating the process of fiscal consolidation in the context of the 1994/95 budget, as a means of returning the economy to a low-inflation growth path. Important initiatives have been taken in the new budget in the fiscal, monetary, and external sectors. However, the staff points out that the adjustment corrects less than one half of the fiscal slippage that occurred in 1993.

The authorities' position is that a more gradual path of fiscal correction has been chosen as part of a counter-recessionary stance, aimed at facilitating a recovery in activity. The exceptional strength of the balance of payments and the existence of large margins of slack in important sectors of the economy offer some scope for a cautious policy-induced demand stimulus. An additional factor, that is extremely important in the context of the Indian economy, is the cushion provided by sizable food stocks.

These arguments deserve to be considered carefully. The policy challenge facing the authorities was to find a medium-term path that would balance the risks of an aggressive fiscal adjustment accompanied by slow growth, against an outward-looking strategy that could stimulate stronger growth, while mobilizing political support for a subsequent return to a more conservative fiscal strategy. During the 1993 Executive Board review under the stand-by arrangement, this chair argued that:

> A somewhat slower pace of fiscal adjustment, which accommodates the urgent need to increase essential infrastructure investment and recognizes the likely gradual impact of tax reform on revenues, could still be consistent with the authorities' external objectives while strengthening India's growth potential over the medium term. A balanced path of fiscal adjustment in the present circumstances of the Indian economy needs to be mindful of the critical need to reverse the harmful retrenchment in capital spending while cautioning against overly optimistic projections of tax yield. Strong policy action will still be required if India is

to succeed in placing its fiscal deficit on a firmly downward path.

Although the sharp rise in plan-related infrastructure investment expenditures is welcome, it is disappointing that the fiscal slippage exceeded the bounds of reasonable gradualism. Nevertheless, it is unlikely that the deterioration in the fiscal position will overnight plunge the Indian economy into the type of financial crisis that the authorities faced in 1991. Moreover, relying on the external sector to provide a growth impulse sufficient to allow a more forceful return to fiscal correction is not as risky a strategy as it may first appear.

Recent export performance has been nothing short of remarkable; at the same time, input-output-based studies have shown that during 1984/85-1989/90 the import intensity of private and government consumption has declined, while that of capital formation and exports has increased. Thus, although concerns have been expressed that a policy-induced stimulus could quickly spill over into higher imports, this could well be a positive development because much of the additional imports would be intermediate and capital goods, thereby leading to improvements in export potential and productivity. In addition, the pickup in imports could serve as an offset to monetary growth and, through its supply-enhancing effect, help alleviate inflationary pressure.

The potential efficiency gains arising from the continued implementation of key structural reforms and the impact of the substantial inflows of foreign direct investment have greatly enhanced the prospects of India's achieving higher investment and growth rates. Moreover, the direct demand stimulus from the budget should help those industries that have been adversely affected by the strength of fiscal correction in 1991/92-1992/93. It is thus possible that the strategy chosen by the authorities could move the Indian economy onto a robust growth path.

Nonetheless, important policy challenges will remain. From a macroeconomic policy perspective, the authorities will have to be careful once the recovery gets firmly under way, to strike the right balance between managing the forces of expansion and observing the need to return to a path of fiscal consolidation. The staff report sets out very clearly the risks of the Government's strategy and the potentially adverse effects of continued large fiscal deficits on financial stability, growth, and competitiveness. The report also makes it clear that the authorities are well aware of these risks and that they will remain vigilant against signs of unsustainable demand pressures.

Furthermore, although much has been achieved on the structural front, a considerable agenda of reforms still remains

to be implemented. The present strength of the external sector offers the authorities a unique opportunity to strengthen their efforts in those areas in which progress thus far has been slow. There is a clear lack of reform symmetry between the revenue and expenditure sides of the budget. The authorities have commendably remained faithful to the recommendations of the Cheliah Report. Similar efforts would be useful for the rationalization of expenditures. Thus, while it is important to sustain the momentum of tax reform, greater attention must be paid to devising effective measures to control noninterest current expenditures. Further steps in the area of trade, public enterprise, and financial sector reform would also be important. Indeed, we continue to regard the formulation of effective policies to rehabilitate public sector enterprises, including exit policies, as crucial to the success of all other reforms and essential to the goal of lowering India's high, economywide incremental capital-output ratio. The authorities should also be strongly encouraged to move toward an early acceptance of the obligations of Article VIII.

The attention given in the supplement to the appropriate policy response to the recent surge in capital inflows is timely. Although these inflows have afforded India the opportunity to build up a comfortable cushion of reserves, their continuation adds to pressures on monetary aggregates and the price level. The confluence of these developments presents the authorities with difficult choices. Although sterilization of reserve accumulations remains a useful tool, its extensive use would deprive the economy of the benefits of the capital inflows sought in the first place, while maintaining the interest rate incentive for additional flows.

In the absence of a prompt adjustment in the fiscal position, and assuming that the authorities would be reluctant to accept the effects of a further acceleration in inflation emanating from this source, adjustment to capital inflows would have to take place through an appreciation of the exchange rate. A gradual rise of the rupee should be seen as an integral part of a strategy to counteract inflationary pressures and to cool off the economy if evidence of overheating emerges. Other measures to deal with a surge in capital flows would be speeding up the process of trade liberalization measures--raising imports--as well as a graduated relaxation of outward capital controls. Concerns about external competitiveness should be addressed by actions to raise productivity, rather than resisting market pressures for an appreciation.

Before concluding, I would like to touch upon a delicate issue. An aspect of India's 1994/95 budget that is disturbing to my Pakistani authorities is the year-on-year 20 percent increase

in defense expenditures relative to the budget allocations for 1993/94. As the staff explains, higher defense expenditure was the "result of the greater than anticipated impact of exchange rate unification on the cost of military imports," as well as inflation. Nevertheless, this increase is a regrettable development. Directors will recall that, despite continuing tensions in the region, my Pakistani authorities actually reduced defense expenditures by almost 1 percent of GDP in their budget for 1993/94 and expressed their intention to contain defense spending over the medium term. It was my authorities' hope that their decision would help bring about a de-escalation of regional tensions and pave the way for a mutual reduction in defense spending.

Finally, I would like to thank the staff for responding to Executive Directors' requests for a study of exchange rate behavior in a regional context and for having included a section on exchange rate issues in the background paper. Although largely retrospective in nature and constrained by data limitations, the study provides a number of useful insights. We look forward to an update of the present findings as newer, more disaggregated, and better data becomes available.

Mr. Evans made the following statement:

India is in the process of transforming its economy, getting rid of a huge web of controls, reducing the role of government, establishing its external creditworthiness, and attracting foreign investment. As Mr. Geethakrishnan says, the Indian authorities are aiming at integrating the Indian economy with the global economy. The international capital markets are responding with a surge of inward investment. There is great potential for faster sustainable growth in India if the momentum of reform can be kept up. But the welcome vote of confidence in the Indian economy over the past year should not be taken for granted; real risks remain.

India designed its far-reaching economic program following the 1991 balance of payments crisis, with the help of Fund advice and supported by a stand-by arrangement. This program was a powerful combination of structural reforms and macroeconomic stabilization. As the Financial Times said on Wednesday, March 30: "India is beginning to enjoy the first fruits of the economic transformation it launched three years ago." The authorities are now in a position to make early repurchases to the Fund. At the beginning of this year, there was widespread hope and expectation that the Indian budget would strengthen the momentum of reforms in two directions: structural reforms and macroeconomic stabilization.

I welcome the further steps that have been taken in this year's budget to extend the policies of deregulation, especially by liberalizing the external sector, including lifting exchange controls on the current account and cutting restrictions on exports. These developments will benefit both India and its trading partners. The abolition of industrial licensing and the ending of most state monopolies are also welcome. But there is still some way to go in reducing tariffs and eliminating import barriers. I agree with the staff that continued sizable flows of foreign capital will provide the opportunity for a faster liberalization of the external sector.

Overhauling the antiquated tax system and reducing its excessive marginal rates are priorities for reform, and I welcome the moves in the 1994 budget that will reduce tax-related distortions and raise revenue elasticity. There is, however, a substantial agenda for further structural reforms: the trade regime remains extremely restrictive; the tax system is still excessively complex, with too many exemptions; further financial sector action is needed; and there is a need to free up the labor market. In particular, I would pick out telecommunications and other public enterprises as priority areas for action.

Early successes in bringing the fiscal deficit toward a sustainable position have been undermined, partly by revenue losses incurred by liberalization, but also by election-related and other spending overruns. As far as the 1994 budget is concerned, the target of a 6 percent deficit is not particularly impressive and relies on optimistic assessments of revenues and expenditure. I fear that the budget falls well short of what is required to achieve a sustainable budgetary position.

The Minister of Finance, Mr. Manmohan Singh, has admitted that he is taking a calculated risk with the public finances by permitting high levels of public borrowing. This is indeed a risky strategy. The authorities are now taking the risk that private sector activity will be crowded out by public borrowing and debt servicing, boosted by the increasing burden of debt. Moreover, there remains a need for effective fiscal consolidation at the level of the States. Without such adjustment, their persistent financial problems could undermine the progress achieved by the Central Government.

I see a number of dangers in the weaker budgetary position. These include the probability of aggravating the growth of monetary aggregates--already under pressure from capital inflows--and therefore requiring higher interest rates; the likelihood of crowding out spending for the infrastructure and maintenance needed to support a strong supply-side response to the reforms; the absorption by the public sector of far too much of national

savings, with obvious dangers for the productive sector, including small firms.

The best way of sustaining the confidence of investors, domestic and overseas, is by keeping up the momentum of structural reforms, including external liberalization; by sticking to--and, if possible, surpassing--the modest 1994/95 fiscal targets; and by taking further steps, as soon as possible, to get the fiscal deficit down to a sustainable level. If India can follow this path--and the past three years have demonstrated that it can--much of the enormous potential of the Indian economy and people can be realized.

Mr. Murphy made the following statement:

The Indian authorities have been engaged in a massive restructuring of the economy since 1991, and the Board commended them at the most recent Article IV consultations for policies that moved away from regulation and control, toward the strengthening of competition and efficiency. On that occasion, the short-term course of fiscal consolidation gave Directors satisfaction, and their concerns were directed at the medium-term stance, which, they then thought, should be as front-loaded as possible, with a shift in the pattern of current expenditure toward education and health, as well as greater emphasis on infrastructural expenditure and social safety nets.

The situation now facing the Indian authorities has changed considerably. The external account has continued to develop in such a manner that the authorities have accumulated further external reserves, now equivalent to over seven months' imports, based on a reduction in the current account deficit, and strong capital inflows representing some direct and much portfolio investment. Faced with this outturn, the authorities are moving to reduce India's indebtedness to the Fund, and are not seeking to use Fund facilities, at least in the short term, although they emphasize that they would approach the Fund if circumstances were to change.

The improvement in the external account appears to be taken as a sign of economic well-being surpassing its true significance. It is set in a fiscal landscape that is bleak: an outturn for 1993/94 that was extremely weak; a budget for 1994/95 that embraces a soft target for the government deficit, and considerable downside risk; and an absence of quantified commitment to adjustment in the medium term. In addition, some contributing factors may be transient.

It is by no means the case that all short-term policy decisions, even those affecting the fiscal position, should

attract negative comment. For example, there is an important tax reform underlying this year's budget, which the staff has rightly said "will substantially improve the tax system." However, the overall fiscal disposition is so sufficiently weak that I single it out for special mention. Otherwise, I will mention only a few specific points for emphasis, as I concur generally with the staff's analysis.

Chart 1 of Supplement 1 to the staff report for the 1994 Article IV consultation tells the fiscal story quite dramatically: the gap between budgeted and actual government deficits was eliminated between 1990 and 1992--when the deficit was between 6 and 6 1/2 percentage points of GDP--only to emerge again, becoming even larger than before through 1994--equivalent to 2-3 percentage points of GDP, with the deficit approaching 7 1/2 percent of GDP. The staff chronicles the factors contributing to this outcome, divided between those affecting revenue and expenditure. I believe that these can properly be described as slippage in many or most cases, that is, arising from circumstances unforeseen or evolving at a pace other than the budgeted one. What is disturbing is the authorities' response to them. Neither the staff report nor Supplement 1 affords evidence of effective action in the very short term to offset the emerging derailment of fiscal policy last year. Thereafter, for 1994/95, the authorities are budgeting for another relatively large deficit, and even that budgetary disposition involves considerable risks. There is little to indicate that the revenue targets can be achieved, and expenditure control calls for a major effort. Looking to the medium term, the authorities have yet to firm up their proposals. All of this provides the setting for the difficult policy choices set out by the staff and its analysis of sustainability of policies in the medium term. In the circumstances, the Indian authorities would do well to give particular attention to establishing a credible and sustainable medium-term fiscal strategy, and to back it up with sustained implementation, which would give room for private sector development, take pressure off emerging inflationary forces, and avoid undermining the external balance.

The role of the Government in the ownership and direction of the economy is a related issue on which I will comment. Appendix Table 2, on pages 23-25 of the staff report, gives a useful summary of structural issues, goals, progress, and staff comments, showing the enormous scale of the task in hand, the considerable work thus far undertaken--for which the authorities are to be commended--and the large task remaining. I will not review the area in detail, but I would pick out financial sector reform as deserving a high priority, in view of its role as intermediary for large capital inflows and in the future development of the economy, as well as its importance for monetary policy

implementation. The staff report makes worthy recommendations regarding reserve requirements, interest rate floors, and profitability of the nationalized banks. However, the banking sector could do with a more forthright confrontation of its fundamental future needs, especially the involvement therein of the private sector.

Finally, I turn to the question of the financing of the States and its role more generally in the financial policies of India. This has been discussed in the Board in the past, and the tendency has been to point to the limited possibilities for action by the center to influence the States. However, in view of its importance, it is essential that such financing should be a part of general financial consolidation, and it therefore seems worthwhile to urge the authorities, once again, to use the leverage that they have--detailed by the staff in the most recent Article IV consultation--to secure as coherent a total public sector financial strategy as possible.

Mr. Torres made the following statement:

The staff report for the 1994 Article IV consultation with India provides a clear analysis of the recent developments and policy challenges faced by the Indian economy. In our most recent statement on India, we highlighted the generally satisfactory progress made under the stand-by arrangement since the implementation of the economic program in 1991. In a very short period of time, the authorities have been able to address successfully most macroeconomic imbalances and recover economic growth. These achievements have been one of the main reasons behind the substantial increase in foreign investment that has taken place in the past two years. As Mr. Geethakrishnan says in his statement, "the figures speak for themselves."

However, we are concerned that fiscal slippages during 1993 seem to be threatening some of the achievements of previous years. According to the staff report, the overall public sector deficit is projected to be about 10.5 percent of GDP in 1993/94, which is a considerably high figure by any standard. Prices have started to rise, and medium- and long-term interest rates remain high, owing, to some extent, to large government borrowing requirements.

We agree with the staff that the improvement in the external position should not allow complacency on the fiscal front. We are concerned that although the authorities recognize that the projected fiscal deficit is too large, there do not seem to be any specifics or detailed plans to address it. We understand the complicated political nature of fiscal adjustment; nevertheless, it seems the authorities could build on their already considerable

economic success in order to further the process of fiscal consolidation, so that the momentum of the reform is not lost.

Success in reducing inflation will require substantial fiscal retrenchment. This is also an essential element in maintaining the external current account deficit at a reasonable level. In that context, it is important that the 1994/95 budget reflect the necessary adjustment for returning to the path of fiscal consolidation. The tax reform efforts described in the authorities' reform agenda, as well as the price adjustment for food and energy products implemented in January 1994, are welcome steps in the right direction.

We concur with the staff's point of view that, in order to maintain price stability, in view of the fiscal deterioration, the authorities should be ready to tighten monetary policy. In that regard, we welcome the authorities' intention to maintain a target of no more than a 14 percent increase in broad money by increasing open market operations. It is deemed particularly important that the authorities swiftly continue the process of decontrolling interest rates, as the structure of the rates is still heavily influenced by the remaining controls.

The stabilization process initiated in 1991 was accompanied by the implementation of structural reforms. The progress already achieved seems substantial. However, it is important to accelerate this process because it could provide significant leeway in the management of fiscal policy. The Government has extraordinary space for action in the restructuring of the public sector. A large privatization program may be, at this stage of the economic recovery, the single most important structural reform measure to be undertaken by the authorities. It should contribute notably to fiscal consolidation, efficiency gains, and attract more foreign direct investment. It would also send a very clear signal about the strong commitment of the authorities to economic reform.

We encourage the authorities to continue in their efforts to allow market fundamentals to determine the value of the rupee. In this regard, sound macroeconomic policies aimed at reducing the imbalances in the economy will be crucial.

We welcome the authorities' intention to pursue their economic reform within the framework of a program that may have Fund support. This may be a good opportunity to strengthen the fiscal stance and enhance structural reforms.

Mr. Ismael made the following statement:

India's progress in addressing the roots of its 1991 foreign exchange crisis is commendable. But the moderate expansion of the Indian economy is both the legacy of its past economic regime and a reflection of the enormous tasks that are yet to be accomplished. India should be content to grow at its own sustainable pace. The country will be undermining its recent hard-won gains if it prematurely attempts to accelerate growth by the recent turnabout in fiscal policy. Experience teaches us that benefits from such a stop-start policy are small and transient. But the cost to India may be high, with a flare-up in inflation, loss of credibility, and erosion of competitiveness.

There is a view that the critical issue for India is not so much what needs to be done, but rather the sequencing and the pace of its reforms. I do not share this view. This is a crucial juncture in India's economic rearrangement toward a more market-driven regime. Some reforms, like taxes, are well into their programs, while others, such as trade liberalization, have a long way to go. Still others, such as the privatization program, have not progressed at all. But the most serious are those, such as fiscal consolidation, that have changed course in midstream. When a major reversal occurs, the reform momentum is lost, putting the whole program at risk.

India's growth rate lags behind those of several countries in East Asia. The World Bank study entitled The East Asian Miracle did not find any miracle. Instead, it found that economic dynamism in these countries was firmly anchored in economic stability and prudent economic choices. Other major contributing factors were the fast rate of productivity gains, the high level of efficiency, and the rapid accumulation of physical and human investment. In reading the excellent staff documents on India, it struck me that India should emphasize the need to improve its effectiveness and efficiency in many areas of the economy. For brevity, I will only comment on two of them--public service and investment.

Regarding public service, the size of India's public sector is among the highest in the world, accounting for 70 percent of the formal sector labor force. This translates into 1 out of every 44 individuals being a public employee! Government wage settlements are automatically adopted by state enterprises, with little linkages to efficiency, cost recovery, or productivity. This huge public sector salary bill carries a very high opportunity cost in terms of resource allocation. I would hope that the streamlining of the public service will be a high priority for the authorities' reform agenda. Such a reform will nicely complement the commendable efforts being exerted on the tax

front. I am interested in knowing whether such a public service review has recently been undertaken. If so, what measures are being implemented or under consideration in this very important area?

On investment, the World Bank study on the East Asian experience indicated that growth accelerated when government intervention was reduced. India should not deviate from its aim of setting up an efficient and nondistortionary playing field for investors and producers. Discriminatory industrial policy based on sector or commodity is counterproductive and should be continuously watched and progressively eliminated.

Based on recent trends, there is optimism that private sector investment will grow by a substantial 5 percent of GDP in the next four years. But the level of investment alone is not complete; the quality of investment is also paramount. India should raise the effectiveness of investment if this anticipated higher rate of private investment is to be fully translated into faster economic growth. Propping up loss-making public enterprises is undesirable and should be treated as a losing proposition. The privatization program appears to have stalled, as the number of operating public enterprises has remained basically unchanged. More important, the number of those incurring losses still accounted for 43 percent of all enterprises in 1993. If there is to be any lasting improvement in the effectiveness of public spending, efforts should be made to encourage these public enterprises to actively participate in the structural reforms. Institutional strengthening and change in the work culture are areas that need to be encouraged as well. India will do well if the rate of physical and human capital accumulation is complemented by innovation, technological absorption, and leaner organizational structures.

In conclusion, I welcome India's intention to accept soon Article VIII status.

Mr. Posthumus made the following statement:

After many decades of state intervention and planning with restrictive industrial, trade, and financial policies--of course never seen that way at the time--India has demonstrated a remarkable capability to break through and initiate an ambitious stabilization and reform program. We all remember India's balance of payments crisis of 1991, and the Fund's involvement in the measures taken by the authorities to face the crisis. The shock provided the incentive for radical therapy by the Indian authorities. I am deeply impressed by the change in course that started then.

I share with other members of the Board the concern about fiscal policy in India. The specific reason for concern is that the structural reform process that is unfolding in India may be endangered by fiscal slippage and the acceleration of inflation. It seems that the economic restructuring that takes place is itself a major cause of the obvious stagnation in investment and production. The experience in the transition countries, where reform is a substantially broader and deeper process, indicates that it takes time before the positive effects of reform--new investments, new enterprises, and new markets--materialize. The reform is still under way, and the progress is therefore also uneven. We also know from the still limited experience in a number of transition countries that stabilization is a vital factor for a market-oriented restructuring of production.

Therefore, macroeconomic policies cannot, in my view, at this stage be successful in increasing employment opportunities and growth. Here, I have perhaps a little difference of opinion with Mr. Geethakrishnan and his Indian authorities. The restructuring process, at this stage, leads to an inability to react to increasing demand in the sectors and enterprises where restructuring takes place. The monetary accommodation of the fiscal slippage can therefore not be absorbed and will lead to inflation. The increased government borrowing on the capital market crowds out private sector financing. I therefore support the staff's advice to strengthen fiscal policy this coming fiscal year and to tighten monetary policy. This advice is difficult to give when the 1994/95 budget proposal has only recently been made. I should like to hear from the staff or Mr. Geethakrishnan on whether a further fiscal correction in the 1994/95 budget is still feasible from the technical point of view, but also from the political point of view.

I would also like to get some clarification of the staff's advice on exchange rate policy. In the supplement to the main paper, the staff considers it necessary to allow some appreciation of the rupee, adding that the inflow of speculative capital that might then occur should be discouraged by "opening the possibility of a subsequent depreciation." However, the authorities do not have a specific target for the exchange rate and intend to allow market fundamentals to determine the external value of the rupee. Under such a policy, I do not see how the possibility of depreciation can be allowed following a period of appreciation.

My statement can be kept rather short by not indicating which policies I support--which, in fact, are most policies. This past month, we went to Rajasthan, a State in India where we visited a nature reserve for tigers. No tigers were in sight--they were probably all sleeping. With a continuation of the present reform policies in India, I am sure that we will witness the awakening of

another Asian tiger, and I am looking forward to my next visit to India.

Mr. Abbott made the following statement:

This chair has been a strong supporter of India's impressive efforts to achieve the ambitious stabilization goals pursued in 1991-93 with the help of Fund support. Under the stand-by arrangement that expired in June 1993, a major reform effort was set in motion to address the serious internal and external imbalances that had emerged in 1991. At the Board's most recent review of India's progress under the stand-by arrangement, we commended the authorities for their substantial success in reducing the government deficit, slowing inflation, pursuing more appropriate exchange rate policies, liberalizing the trade regime, and setting in motion a number of key structural reforms.

In recent reviews, this chair has been a strong, enthusiastic supporter of the reforms and adjustment policies that India has been following. However, the staff's candid report for this year's Article IV consultation leaves us less enthusiastic about the direction of India's present adjustment strategy. Our disappointment with the sidetracking that was detailed in the report was further reinforced by the March 21, 1994 supplement following the passage of the Indian budget. The original report was alarming enough in its projections of macroeconomic developments and policy slippages in 1993/94 on both the fiscal and monetary fronts. These slippages were characterized by revenue shortfalls, higher expenditures, rising inflation, and burgeoning money supply growth. The revised figures in the supplement painted an even more discouraging picture of performance at the end of the fiscal year: the central government deficit widened to 7.3 percent of GDP, and the overall public sector deficit rose to 11 percent of GDP. These figures are getting close to where they were prior to the crisis, when broad money supply grew by 16 percent--compared to the original target of 12 percent.

These factors were, however, balanced to some extent by the stronger than anticipated balance of payments adjustment, for which India should be duly commended. Export volume grew by an impressive 21 percent, leading to a substantial decline in the current account deficit. India's liberalization program has led to continued high levels of foreign capital inflows, which have contributed to a very large cushion of official reserves of $14 billion and a comfortable 7.4 months of import coverage. In view of these indicators, the stage should have been set for accelerated reforms.

Unfortunately, now that the reforms set in motion in 1991 are clearly beginning to pay off, macroeconomic policy has drifted off course. Those reform policies emphasized internal deregulation, reduced subsidization, trade liberalization, and openness to foreign investment. Maintaining the momentum will require a shift away from state dominance of the economy to allow a freer and more expansive private sector. This in itself necessitates a stable macroeconomic framework stemming from firm monetary and fiscal policies, combined with a freeing up of resources from the public sector. The Government's enormous borrowing needs must be pared back to reduce pressure on interest rates, make more productive use of capital inflows, and make more resources available to the private sector.

The scale of new foreign investment in India's economy attests to the confidence that the reforms initiated in 1991 have instilled in the international community. Likewise, the strong improvement in Indian exports demonstrates the responsiveness of the economy to economic initiatives. The authorities need to capitalize on the initial gains that have been made in order to sustain economic growth within a stable macroeconomic framework over the medium term. As outlined so candidly in the supplement to the staff report, India's recently announced budget falls far short of that task, leading us to the conclusion that India's economic policy no longer has the strategic coherence that attracted us few years ago.

The 1994/95 budget projects a central government deficit of 6 percent of GDP, which, as the paper notes, would correct less than half of the fiscal slippage that occurred in 1993/94. The staff's projections that the current budget will result in a public sector debt burden of over 90 percent of GDP at the end of 1994/95, with total interest payments on that debt rising markedly from the already high level of 6 percent of GDP, confirm the misdirection of fiscal policy.

On the revenue side, the focus in the budget is on tax reform. Measures to reduce tariff and tax rates and initial steps toward a value added tax are important and will enhance the efficiency and transparency of the tax regime. Although these measures are welcome, more needs to be done to simplify the rate structure and further reduce the number of exemptions. The critical issue of integrating the Central Government and the state tax regimes remains unaddressed. We share the staff's concern that the weakness of the envisioned revenue measures could lead to difficulties in meeting even the modest revenue targets in 1994/95.

As the tax package is, according to the staff, "revenue neutral, at best, in the short term," scaling back expenditures

becomes even more critical. Here, as well, the budget does not go far enough. Central government expenditure is slated to be reduced by 1 1/4 percentage points of GDP, but how the authorities intend to achieve this goal remains unclear. We welcome the staff's views on this, and in particular, its views on where cuts will be made if revenue shortfalls emerge.

The staff report outlines in detail the authorities' structural reform efforts in a number of areas. I will touch on only a few of these. First, we were pleased that the budget included a phasing out of the Government's automatic access to Reserve Bank of India credit, and we encourage the authorities to accelerate these steps where possible. But this needs to go further. Automatic access to Reserve Bank of India credit is just one element in a clear pattern of banking system--and monetary policy--deference to the voracious public sector borrowing requirement.

Financial sector reform is a high-priority area where there has been some clear initial progress, but much more remains to be done. Specifically, high cash and statutory liquidity ratios need to be reduced, interest rates and capital controls need to be fully liberalized, and priority-sector lending requirements need to be eliminated to address the severe distortions in India's financial sector. In addition, we urge the authorities to redouble their efforts to reduce government involvement in the financial sector, in order to increase competition, lower intermediation costs, and increase the role of market forces in credit allocation.

We noted with interest that some further trade liberalization measures were implemented on March 30, 1994, including the limited issuance of import licenses for selected items currently banned--mainly consumer goods. In view of the highly distortionary impact of quantitative restrictions and the protectionist signals that such restrictions convey, we would urge the authorities to build on the success of earlier trade reforms by imposing tariffs on consumer good imports in the near term.

As this chair emphasized in 1993, although public enterprise restructuring and exit policies for loss-making firms have been on the reform agenda for some time, little progress has been made in those areas. These reforms would make major contributions to both public sector budget controls and the operating efficiency of the Indian economy. We continue to encourage the authorities to accelerate their efforts in these areas.

In conclusion, India has made clear strides in making its market attractive to international capital markets should be congratulated on the success of its reforms. However, a number of

other countries have kept pace and, in many cases, are going further to make their investment climates more welcoming. If India is to remain competitive in the race for limited investment funds, it has to meet the market test, bearing in mind that capital can flow out as quickly as it can come in. We would underscore the staff's assessment that, although the surge in capital flows has eliminated the need for exceptional foreign financing in the near term, India's external viability is not yet assured. The authorities' view is apparently a much more optimistic one; we believe that caution is warranted.

Like Mr. Posthumus, I would be interested in a further discussion by the staff of India's exchange rate policy. The authorities do not have an exchange rate objective, but they do have a current account objective. The current account objective is a deficit equal to about 1 percent of GDP. I would be interested in hearing the staff's views on the appropriateness of this objective, as it appears that India can be an attractive host for foreign investment. As regards the exchange rate target, we believe that a slight appreciation of the exchange rate in the current period might be the appropriate response to a surge in capital inflows, rather than absorbing them in reserves and having to deal with the consequent monetary expansion. We agree with the policy followed until now of using capital inflows to restore international reserves. At the present juncture, however, it might be better to tolerate a little nominal appreciation, as taking excess inflows into reserves risks undermining monetary control, with attendant risks to inflation control.

Mr. Fukui made the following statement:

First of all, I commend the authorities for proceeding in the right direction with economic reform since 1991. It is a pleasant surprise that the authorities have strengthened the external position dramatically by attracting foreign investment. As a result, they have decided to make early repurchases to the Fund this April, although less than three years have passed since the balance of payments crisis in 1991.

However, the authorities cannot by any means afford to relax their strenuous efforts toward economic reform, because the substantial improvement in the external position--at the moment, this is the only area where we can see substantial improvement--is mostly attributable to the recent surge in capital inflows.

According to the staff's analysis, these inflows appear to be largely associated with a general trend for international institutional investors to diversify their portfolios into emerging Asian markets. This analysis is convincing because a similar phenomenon can be seen in neighboring countries, such as

Bangladesh and Sri Lanka. However, it does give rise to concern about the sustainability of the capital inflows, although we acknowledge that the surge in capital inflows partly reflects India's enhanced creditworthiness as a result of the authorities' reform efforts. More specifically, the substantial weight of portfolio investment in these capital inflows, estimated to constitute more than 80 percent of the total, implies the risk of a drastic shift out of the country once this creditworthiness is undermined.

In these circumstances, I urge the authorities to be even more resolute in taking economic reform measures aimed at minimizing the impact of capital inflows on the economy while sustaining the momentum of this economic reform, and without becoming complacent about the abundant liquidity. I would therefore like to ask the authorities to implement a number of measures in a steadfast way. First, they should undertake ambitious fiscal consolidation to partly reduce the risks associated with capital inflows. Second, they should eliminate the restrictions on trade, taking advantage of the buildup in external reserves. Third, they should eliminate controls on interest rates to facilitate a decline in domestic interest rates. Finally, the authorities should implement a new exchange rate policy that would allow some appreciation of the rupee. All of these measures would be effective in avoiding the vicious cycle of capital inflow surges that, by adding to inflationary pressure and requiring sterilization, lead, in turn, to rising interest rates, which consequently attract additional inflows.

Although the authorities agree in principle with most of these measures, it is regrettable that they have not pursued, for example, ambitious fiscal consolidation, which would have laid the basis for macroeconomic stability. It is especially disappointing that the envisaged reduction in the deficit will be less than half of the fiscal slippage that occurred in the 1993/94 fiscal year. This gives the impression that there is another slippage in fiscal policy. Mr. Mirakhor's statement used impressive words: "the fiscal slippage exceeded the bounds of reasonable gradualism." This is precisely the impression that I have. Insufficient fiscal consolidation could further restrain the already limited maneuverability of monetary policy by forcing the authorities to continue sterilization.

On structural reform, I welcome the progress made in articulating a broad framework in almost all of the crucial areas: trade liberalization, tax reform, and the restructuring of the public enterprise sector. However, I am again disappointed to find that details and concrete timetables are still lacking. In particular, like Mr. Evans, I would like to emphasize the crucial importance of tax reform and the enhancement of its administra-

tion. The tax system still contains many distortions and complications stemming from its relatively narrow basis, and tax reform will eventually provide resources amounting to only 8 percent of GDP, which is much lower than in other developing countries.

In more general terms, all these recent measures give the unfortunate impression that India is now losing its strong momentum for economic reform. For example, the supplement to the staff report rightly points out that although a further liberalization in trade was implemented, "these measures fall well short of eliminating the highly distortionary quantitative restrictions on imports of consumer goods." This, by the way, is typical of the comments made by the staff in these papers. We appreciate the initiative taken and the progress made thus far toward economic reform by the authorities, but these measures fall well short of being far-reaching or deep-rooted. I would like to emphasize that, at this critical juncture, India needs to make another strong effort at economic reform before the economic reform process can bear fruit.

With respect to foreign direct investment, this has, according to the experience of other high-growth countries, played a very important role. Although in terms of amounts, foreign investment will be marginal, it exercises a wide influence in developing countries. I welcome the measures taken by the Indian authorities to give some incentive to foreign investment, including the 50 percent rule. I would appreciate it if the staff could give an assessment of the present situation, including the legal framework, and indicate whether there have been any improvements or new initiatives in this area.

According to the report, there was some increase in defense expenditure. We note that this is mainly attributable to the change in the exchange rate, but I share Mr. Mirakhor's concern, and I hope that the staff will continue consultations in this area.

Although India's external position has greatly improved, based on its reputation for having successfully adopted a market-oriented economic policy, external viability is not yet assured, and the authorities still face enormous challenges. I hope that they will strengthen their effort at economic reform and clearly set the pace for sustainable growth over the medium term.

With these remarks, I support the proposed decision.

Mr. Zhang made the following statement:

The authorities are to be commended for their remarkable achievements since experiencing balance of payments difficulties three years ago, in 1991. Inflation has been reduced, economic growth has been robust, and foreign exchange reserves amounted to an historically high level of $13 billion at end-February 1994. The authorities have also made considerable progress in structural reforms. These positive results are mainly attributable to firm stabilization measures--especially fiscal consolidation--as well as to prudent but fruitful economic restructuring efforts.

I appreciate the authorities' cautious approach in pushing ahead with economic liberalization and reform, as presented in the budget for 1994/95. Nevertheless, I am concerned about some of the policy proposals.

The budget deficit for 1994/95, although lower than the actual figure of 7.3 percent for 1993/94, will be higher than the original target of 4.7 percent in 1993/94. More worrisome is the envisaged increase in public sector borrowing. This will force the public and private sectors to compete for domestic savings and will therefore raise long-term interest rates. The unproductive use of scarce domestic financial resources for increased subsidies might squeeze private investment, which is vital for India's sustained economic growth.

The authorities expect that increased budgetary revenue will come from the buoyant economic activity triggered by reductions in the tax rates and the rationalization of the tax system. However, it is risky to depend too heavily on a resumption of economic activity for enhancing budgetary revenue. In 1993/94, economic growth was helped by a good harvest on the production side and buoyant export performance on the expenditure side. The slow increase in private investment and weak government procurement in 1993/94 hampered activity in the manufacturing sector. Although tax incentives in 1994/95 have the potential to improve private investment, larger public borrowing requirements might offset such favorable factors. In addition, as India has enjoyed six good harvests in succession, it is not impossible that external shocks, such as bad weather, will adversely affect agricultural production.

On the expenditure side, the staff indicates that the cuts were unevenly shouldered in 1993/94 by capital spending. In light of the need to constrain government outlays, continued current spending on subsidies, and for other less efficient purposes, will have an unfavorable impact on expenditure and investment. Although continued increases in current spending on subsidies and wage bills will help the authorities bypass the most difficult

restructuring tasks temporarily, they will create more problems for the future. In this context, the authorities should prioritize capital spending. In addition, they are encouraged to take additional measures to keep within the budget target if revenue falls short of and expenditure overshoots the respective targets during 1994/95.

It is encouraging to learn that the authorities propose to place limits on the monetary financing of the deficit. However, increased public sector debt will worsen the nonperforming portfolio held by the financial sector, in particular the banking system. An efficient financial system is indispensable in the move toward a more market-determined mechanism. Therefore, financial sector reform will be critical for the success of future economic reform. However, if the financial position of the public sector does not improve substantially, financial sector reform will become more difficult, causing reform efforts in other areas to lag. Against this background, I encourage the authorities to make every endeavor to improve the public sector's financial position and to scale down its borrowing requirements.

I am delighted that the authorities have made further progress in structural reforms. One of the remarkable achievements of the adjustment program over the past three years is the increased confidence of foreign investors, which has led to increased foreign capital inflows. The continued non-debt-creating capital inflows will be conducive to the authorities' reform efforts, and we encourage them to continue with the reforms in the exchange and trade regimes. At the same time, we caution them that the underlying economic and financial stability ensured by sound macroeconomic policies are the key to maintaining foreign investors' confidence and attracting more foreign capital.

Mr. Autheman made the following statement:

I would like to welcome the information given in the supplement to the staff report that, in view of the further strengthening of the external position, the authorities now see no immediate need for Fund financial support. Moreover, they have decided to make early repurchases of their obligations to the Fund.

I begin with this comment because, when we look at future risks, we should not forget the basic positive news that the successful implementation of the reforms launched in 1991 has led to a situation in which the equilibrium of the balance of payments can be sustained freely, based on market inflows and outflows.

This being said, the lesson to be drawn is that the two pillars of the authorities' strategy that have led to its success

thus far--the consolidation of public finance and the opening up of the Indian economy to the outside world--remain the relevant policies.

At this point, I am somewhat puzzled by the following contradiction. I naturally share the concern expressed by previous speakers that the Government seems to be slowing down the pace of structural reforms--this could even be considered an understatement--and is tending to, if not abandon, at least reconsider the direction of fiscal policy. In other words, I share the concern that the increased room to maneuver provided by the improved current account position may be used too quickly and too often. However, I am at the same time puzzled that both the Indian private sector and the international markets are obviously confident that India's performance will continue to improve, based on the prospect of political stability and the positive assessment of its economic prospects. Are markets overoptimistic? Are we overpessimistic? How can we assess the direction? In any case, I am ready to pay great attention to the view expressed by Mr. Geethakrishnan that the staff and the authorities differ not on substance, whatever the appearances, but on the sequence and timing of implementation of the authorities' strategy.

It is obvious that the question of medium-term fiscal consolidation remains central. The high cost of debt service, the crowding out of private investment--private saving is 20.8 of GDP, and private investment is 14.4 of GDP, both of which are unsustainable balances--the need to make room for infrastructure spending, and the cost of structural reforms all call for stronger fiscal consolidation. At this point, it remains unclear how this fiscal consolidation should be divided in the medium term between further expenditure cuts and further revenue increases. I wonder whether Mr. Geethakrishnan or the staff could comment on this issue.

In the short term, my assessment of the fiscal position will depend on whether the figures will prove right this year. If the outcome is similar to last year's--that is, a targeted fiscal deficit of 4.7 percent of GDP and an actual deficit of 7.2 percent of GDP--the orientation of fiscal policy will be worrisome. If, on the contrary, the Government achieves its target--that is, to reduce the fiscal deficit from 7.2 percent to 6 percent of GDP, through expenditure cuts--greater confidence is warranted.

The large public debt and the opportunities offered by capital inflows, will, in my view, require a slightly stronger fiscal stance, but what will be critical is whether the Government will stick to its fiscal target. In view of this, I agree with Mr. Evans that the Indian authorities should pay greater attention to the two main dangers of the present fiscal policy: that public

spending for infrastructure and maintenance could be squeezed; and that the public sector will continue to absorb too much national savings or that India could rely too much on higher capital inflows, which may not be as positive in the future as they are now.

I would tend to believe that, based on the present climate of confidence, the prospect for capital inflows into India might be even greater than in the past year. What is the Government going to do with this potential further room for maneuver? Will it seize this opportunity to let the imbalance between private saving and private investment be reduced and simultaneously take further actions to reduce the fiscal deficit? I believe that this would be the appropriate step to take. Larger capital inflows should allow for higher imports, and probably a slightly larger current account deficit, if further fiscal measures are taken.

Mr. Abbott raised the issue of monetary policy. In this area, I would call for great caution and a medium-term approach. There might be pressure for an appreciation of the exchange rate, but such an appreciation would probably be considered unsustainable in the medium term by foreign markets and may consequently lead to reversed capital outflows.

On the whole, I am concerned by the risk taken by the authorities to miss some part of the opportunity provided by the prospects of huge capital inflows; however, if the progress expected in the area of fiscal consolidation is achieved, that strategy may be available and may provide continued support to reforms, both through the private sector's and foreign investors' confidence.

My final point concerns structural reforms. The authorities must be commended for the reforms that they have implemented thus far. What should we think of the decision taken to slow down the pace of structural reforms? Obviously, there is a need for many more structural reforms than the present stance allows, but here again I notice that private sector confidence has not been endangered by the decision to reduce the pace of structural reforms. I understand that confidence in the economic performance and in the prospect of political stability in India plays a great role in this respect. Consequently, I can understand that, as long as the direction of structural reform is maintained and remains certain, the authorities have a greater room for maneuver as far as the timing and speed of structural reform are concerned--and that they may decide to focus more on the sound implementation of structural reforms recently introduced, rather than on taking further steps, which may jeopardize the present political consensus.

However, on the whole, I am concerned that the Indian authorities run the risk of going too slowly. To take one example, there is a strong case for stronger trade liberalization in India. Such a liberalization would be a natural consequence of capital inflows and would also probably raise customs revenues.

Other examples could be taken, and I would advocate that, while maintaining the strong political consensus--which in the medium term is critical for sustaining the direction of structural reform--the authorities use the present international confidence in the economy to be slightly more audacious in the pace of structural reform implementation.

Mr. Kagalovsky made the following statement:

I welcome the developments that have been made in India with respect to initiating and implementing a radical macroeconomic stabilization program and economic restructuring. Since the beginning of economic reform in mid-1991, supported by a stand-by arrangement, substantial progress has been made. In this context, I would like to commend the authorities for their commitment to market-oriented reforms.

I would like to make several remarks concerning the most recent developments in India's economic reform. My first remark concerns India's fiscal policy. Important progress has been made in narrowing the central government budget deficit and the general public sector deficit. The tightening of monetary policy contributed to the lowering of the inflation rate and led to the stabilization of the rupee. There have been significant developments in the capital account, with a remarkable surge in foreign direct and portfolio investments, which in 1993/94 reached $2.3 billion. That is ten times the average level of the preceding three years.

However, there have been some slippages in the past year. The central government deficit widened to 7.5 percent of GDP from a targeted 4.7 percent. The deficit increased as a result of a revenue shortfall, an expenditure overrun, and a sluggish economy. On the revenue side, the inelastic, complex, and inefficient tax system--which still allows many exemptions and has a narrow base for indirect taxes and high corporate tax rates--had an impact on the fiscal position. I would like to welcome the first steps taken on the road to improving India's tax system--the reduction of taxes for Indian and foreign companies by almost 10 percent and the introduction of changes to indirect taxation. Still, these are only the first steps. Major tax reform with medium-term goals is under way. This reform includes further extending the tax base, simplifying the tax structure, and introducing a fully

integrated value-added tax, and it will certainly lead to fiscal improvement.

On the expenditure side, there is a clear need to limit the practice of widespread subsidization of the ailing public enterprises, which is the main burden on the government budget and appears to be the moving force in deficit overruns. Furthermore, I wish to emphasize the need for limiting the financial transfers to the States. The chronic fiscal deficit of the States--equal to 3 percent of GDP in the budget of 1993/94--has also had an obvious negative impact on the overall picture of the fiscal deficit, although this was somewhat reduced during the past three years. Reducing the fiscal deficit of the States is imperative if the Central Government is to succeed in implementing the program of financial consolidation. In light of the need to reduce expenditures, further cuts in defense spending are crucial.

As for monetary policy, financing the fiscal deficit resulted in the expansion of broad money and led to a rise in the inflation level to 10 percent in March 1994. In this light, the Government's plan to put strict limits on deficit financing by the central bank seems significant. This is a signal that monetary financing may be phased out altogether. Furthermore, I would like to express concern about the sharp increase in capital inflows, which add to the pressure on monetary aggregates and inflation. I would agree with the staff's suggestion that a moderate appreciation of the rupee would be appropriate in this case.

Speaking of structural reform, there is a clear need for further structural adjustment. India's economy is characterized by a restrictive trade regime, controls on key agricultural exports, and quantitative restrictions. Although tariffs were cut from an average of 75 percent to 47 percent, and export bans were removed from 61 items, leaving only 7, there is clearly still scope for further improvement. I would also like to note some positive effects of the price adjustment policy, which is aimed at improving government finances by 0.5 percent of GDP. This policy, which includes the decontrol of administered steel prices and most imported fertilizer prices, has increased flexibility in the setting of petroleum and coal prices, and established a uniform minimum retail tariff on electricity. A certain number of achievements in trade deregulation have also been generated. Many restrictions on obtaining import licenses and state approval of investments were abolished. In this regard, the information that we received this morning in the statement by the Deputy Director on further trade liberalization is encouraging.

As for the reform of the financial sector, the statutory liquidity ratio, which had been used to channel banks' funds into government securities at below-market interest rates, was reduced

to a level of 34 percent of deposits. Competition among banks was enhanced: four new banks were organized, and several mandatory requirements for lending to large borrowers were considerably relaxed.

The formulation of an exit policy and public enterprise reform are the most vulnerable parts of restructuring. Some steps have been taken to privatize state-owned entities, but progress has been regrettably slow in achieving privatization goals and in reshaping the public sector. I support the staff's view on the need for developing a concrete privatization program and strategies for the successful functioning of the private sector. During the 1993 discussion on India, this chair expressed concern about the privatization process. The poor performance of state-owned enterprises, with 102 out of 236 public enterprises recording losses in the 1991/92 fiscal year, generates a chronic financial deficit. Some progress had been made in this area, with the restructuring and closure of "chronically sick" enterprises, but the scope for further restructuring of the public enterprise sector remains substantial.

I would like to conclude by briefly referring to India's external position, which strengthened during the past fiscal year as foreign exchange reserves reached 7.4 months of imports in March 1994 and export volumes grew by about 20 percent. Unification of the exchange rate in March 1993 and the further liberalization of the exchange system led to the stabilization of the rupee and had a positive impact on the financial situation.

The Indian authorities indicated that they saw no immediate need for financial support from the Fund, and India will repay the Fund $1.4 billion in principal and interest next year, using its accumulated reserves. India's authorities are currently implementing measures to move toward current account convertibility, and they anticipate the acceptance of obligations under Article VIII in the near future. I support elimination of the restrictions and the multiple currency practices, as well as the restrictions on invisible transactions, including exchange restrictions on pensions and study and travel abroad. In this regard, I welcome the Government's intention to further lift restrictions. I strongly agree with the staff's view on the desirability of the adoption of Article VIII status, which will provide a clear signal of India's transition to a more open economy.

I very much hope that the Government's efforts to achieve accelerated sustainable growth--based on macroeconomic stability--will be successful, and that the Indian economy will show good results in the mid-term perspective. With these remarks, I support the proposed decision.

Mr. Martinez Oliva made the following statement:

On the occasion of the most recent review of India's performance under the stand-by arrangement, Executive Directors commended the Indian authorities for the success achieved in implementing their program of economic stabilization. Substantial progress had been attained with fiscal consolidation; the inflation rate decreased; the slowdown of economic activity was being reversed; and important structural reforms were being implemented. However, the sizable slippage of the central government deficit, which, according to the staff's estimates, has widened to almost 7 1/2 percent of GDP--more than 2 1/2 percentage points above the budget target--is putting at risk the continuation of the progress achieved thus far. Indeed, the deterioration of public finance could involve a reversal of the favorable trend of macroeconomic performance and force the authorities to face a difficult policy dilemma: whether to accept a higher inflation rate or to tighten severely monetary policy, which would ultimately increase the public sector interest burden. Moreover, as Mr. Evans has correctly pointed out, this deterioration could have undesirable crowding-out effects at the expense of infrastructure expenditure and private saving.

Accordingly, as many other speakers have remarked, efforts to improve fiscal administration and to decrease the size of the deficit are essential to the stabilization of the economy. This is the key element in the Indian economic program for 1994/95, which envisages a reduction in the central government deficit to 6 percent of GDP, consistent with an overall deficit of about 10 percent of GDP. In general, I agree with the staff that the fiscal consolidation effort should be achieved primarily through revenue-enhancement measures--aimed at broadening the tax base and simplifying the tax structure--as the need to improve infrastructure and provide resources for necessary social projects constitutes a limit to the amount of expenditure cuts that can be taken. Nonetheless, in agreement with Mr. Kagalovsky, I have the impression that the authorities' action would be strongly reinforced by more resolute measures to impose fiscal discipline on state governments by including the States in the fiscal reform, and inducing a revenue mobilization at the state level. This would help to prevent the stabilization efforts at the central level from being undermined by measures taken at the regional level, as this chair already noted in the past year's discussion. I am aware that, as the authorities have stressed, the Central Government has only limited direct leverage in India's federal system over the States' financial policy. I nonetheless wonder whether such a situation could call for a reform of this field.

In the event of further slippage in the fiscal area, the scenario elaborated by the staff is particularly negative. In

such an event, should the real interest rates remain high, they would have extremely negative effects on government debt-service payments, lead to a deterioration of bank portfolios, and put upward pressure on exchange rates. Therefore, we warmly endorse the staff's conclusion regarding the need to establish the credibility of the proposed fiscal adjustment by implementing the necessary reforms in the 1994/95 budget.

Concerning monetary policy, it is important to point out that the task of controlling monetary aggregates has been complicated by the recent surge in capital inflows, which, together with the fiscal slippage, constitutes a source of inflation risk. On this issue, I share the view of Mr. Autheman that capital inflows could become an undesirable feature in the medium term. Thus far, the monetary impact of these flows has been partially sterilized through open market operations. Even though this practice has provided some relief, it is unsustainable over time, especially as the instruments available for open market operations are still limited. The development of a secondary market for government securities would certainly improve the situation. However, I concur with the staff that eliminating the source of the problem, namely, abolishing interest rate controls, would help stabilize capital flows by allowing rates to decline.

It is also important that the financial sector reform be targeted in such a way as to allow enough credit to finance private activities. According to the staff report, a large part of the new banking deposits is still being automatically channeled to finance the Government--at interest rates below those prevailing in the market--through the imposition of the statutory liquidity ratio and the priority-lending requirements. The planned continuation of the process of gradually reducing these restrictions is certainly welcome, as it will help to reduce the crowding out of private investment, as well as increase the profitability of the banking system.

As far as trade liberalization is concerned, I encourage the reduction of barriers to international trade, which have been the cause of significant distortions in the economy. The measures defined in the program include tariff cuts in several classes of products, according to their stage in production--with higher tariffs for final-demand goods. I agree with the staff that this differentiation might cause dispersions in the effective protection rate among goods.

With these comments, I thank the staff for the excellent papers, I encourage the Indian authorities to firmly continue their stabilization efforts, and I wish them the best success in the achievement of their goal.

Mr. Toé made the following statement:

Let me first of all commend the staff for the well-focused and balanced report prepared on the 1994 Article IV consultation with India and for the insightful and informative background paper.

Second, I would like to join previous speakers in commending the Indian authorities for the remarkable progress achieved under the 20-month stand-by arrangement that expired in June 1993. It is most encouraging to note that the authorities' program of fiscal consolidation and structural reform, supported by the stand-by arrangement, has enabled them to avert the major balance of payments crisis that loomed large in October 1991 and to reduce the central government deficit, as well as the rate of inflation. More important, external confidence in the Indian economy has been restored, foreign exchange reserves have been rebuilt to a comfortable level, and a promising start has been made in addressing the severe structural distortions that have been plaguing the economy.

It is regrettable that these commendable achievements could not be sustained under the interim program monitored informally by the staff for the first half of 1993/94. Fiscal slippages led to increases in the Central Government and public sector deficits, and the ensuing accommodative monetary policy followed by the Reserve Bank of India contributed to a reversal in the downward trend in inflation.

I can associate myself with most of the comments made by the previous speakers, in particular those made on the urgency of a credible fiscal consolidation package and the adoption of a program of action for structural reforms in all the "core" areas identified in the staff report. As I am in general agreement with the thrust of the staff appraisal, I will limit my comments to these two pressing issues.

On fiscal policy, I note that, in view of the slippages that occurred in 1993/94, the staff has recommended to the authorities the adoption of a fiscal consolidation package containing an appropriate mix of revenue measures and expenditure- reducing measures, with emphasis placed on cuts in noninterest current spending, in particular wages and subsidies. We share the staff's view that such a fiscal package is urgently needed not only to signal a convincing return to the medium-term path of fiscal correction and keep the public debt burden to a manageable level, but also to ensure that the recent gains made in restoring external confidence, as evidenced by the sharp turnaround in India's external prospects, are not eroded. Fiscal consolidation

can be also considered as the authorities' best ally in dealing with the consequences of the surge in capital inflows.

While there is full agreement between the Indian authorities and the staff on the need to further strengthen public savings and on the measures to achieve this over the medium term, there appears to be a slight difference of views on the scope of the measures needed to improve the fiscal position in the short term. Indeed, although the staff recognizes that the progress in tax reform reflected in the budget proposals is substantial and should lay the basis for a less distortionary and more revenue-elastic tax system, it states that "the contemplated fiscal correction falls well short of what is needed to ensure a sound and sustainable budgetary position" and that "achievement of the relatively modest goals for 1994/95 is not assured." The staff then suggests that a substantial deficit reduction in 1994/95 is achievable, provided there is a strong revenue effort.

However, the authorities are of the view that, in view of India's specific circumstances, any strategy other than the present one would perhaps be unproductive and that excessively ambitious objectives would strain the delicate consensus necessary for the success of the overall reform process. We have sympathy with this view, as we recognize the importance of setting realistic fiscal targets that do not upset domestic consensus on, and support for, the reform process. However, the immediate risks to macroeconomic stability posed by the fiscal situation should not be underestimated. These risks are well highlighted in the staff papers, particularly in the supplement to the staff report. We would thus urge the authorities to consider contingency fiscal measures to strengthen revenue mobilization, while striking the necessary balance in order to maintain domestic support. I wonder whether the staff has identified measures that would enable the authorities to move in this direction, and I will be interested in hearing the staff's answer to the question raised by Mr. Posthumus on the feasibility of introducing corrective measures in the 1994/95 budget.

Regarding structural reforms, we are impressed by the long list of actions already taken and would encourage the authorities to bring forward, at the earliest opportunity, the policy initiatives being developed. On several fronts, India is already reaping the benefits of the bold reforms implemented over the past few years. We concur with the staff that an acceleration and a broadening of the reforms to other areas will encourage a rapid response from the private sector and help achieve the authorities' objective of accelerated economic growth by the end of the decade. The trade liberalization measures announced on March 30, 1994 and the authorities' intention to accept the obligations of Article VIII, Section 2, 3, and 4 are welcome.

With these remarks, I support the proposed decision and wish the authorities continued success in their challenging endeavors.

The Deputy Director of the Central Asia Department said that a number of speakers had wondered whether India's actual 1994/95 fiscal deficit could be held to less than the target of 6 percent of GDP. In principle, it was of course possible to do more than the measures described in the staff report. Greater increases could be made in the administered prices, the level of spending could be kept below budgeted amounts, and new tax measures could be introduced, including the tarification of imports of consumer goods. More generally, transfers from the Central Government to the States could be limited, and tight spending constraints could be imposed on the States.

However, the real question was whether such actions were likely to be taken in the present environment, the Deputy Director continued. Moreover, as implied in the supplement to the staff report, meeting the deficit target of 6 percent of GDP was already contingent on the implementation of a number of tough measures. It was thus by no means certain that additional actions could be taken to improve on that target. In that context, it should also be noted that, with the exception of 1991/92, the budgetary targets had been exceeded by significant amounts in recent years.

With respect to medium-term fiscal consolidation, most of the effort would be made on the revenue side, the Deputy Director considered. The room for maneuver with respect to expenditure was limited. However, the quality of spending was an important issue: to promote growth in the economy, a shift in the composition of expenditure from current spending into investment, especially by the States, was needed.

On exchange rate policy, as many speakers had emphasized, dealing with the surprising surge in capital inflows had become an important issue in recent months, the Deputy Director commented. Part of that increase was exogenous, reflecting a generalized shift into Asian markets on the part of international portfolio investors. The surge also had an endogenous component, arising from investors' perceptions of the progress of reform in India. To the extent that the shift was permanent, it was necessary to channel the capital inflows into domestic investment. For that reason, the staff had urged the authorities to move as quickly as possible to remove the remaining distortions in the domestic economy, so as to provide an appropriate environment for the sharp increase in domestic investment.

Over the medium term, the increase in capital inflows could be accommodated by a change in the current account, the Deputy Director noted. Until a few months previously, the staff had envisaged a current account deficit of less than 1 percent of GDP. Clearly, however, if India were to have access over the medium term to much larger inflows of capital, its current account deficit could be sustained at a much higher level. In these circumstances, some appreciation of the real exchange rate would be inevitable. Appreciation could occur in one of two ways: the authorities

could either maintain a relatively stable exchange rate while accepting a higher rate of inflation, or they could allow the nominal exchange rate to appreciate.

At this point, it was too early to know whether India's capital inflows were transitory or permanent, the Deputy Director remarked. Obviously, the answer would depend significantly on whether the momentum of reform was sustained and on the evolving fiscal situation in the country.

In that connection, the staff was not attempting to discourage capital inflows by calling for an artificial appreciation of the exchange rate that would, in turn, lead the market to expect a depreciation, the Deputy Director explained. At present, the authorities were maintaining a stable exchange rate by allowing reserves to accumulate in the short term. However, holding the nominal exchange rate stable was aggravating the situation, as additional inflows were being attracted by the one-way bet implied by high domestic interest rates and the market's perception that the rupee could only appreciate. To the extent that those capital inflows could not be absorbed, either through increased investment or sterilization--and the scope for such sterilization by the Reserve Bank was limited--the exchange rate should be allowed to move in line with market forces. If the rupee were allowed to appreciate, of course, there was always the possibility of a subsequent depreciation--or, for that matter, appreciation; the important point was that the market participants could no longer be assured that the rupee could only appreciate.

The staff was also concerned about the implications for export competitiveness of the surge in capital inflows, especially if those flows turned out to be transitory, the Deputy Director of the Central Asia Department added.

Mr. Posthumus observed that, with respect to the staff's advice on handling the capital inflows, he was not questioning the recommendation to allow an exchange rate appreciation. He merely wondered how, under a floating exchange rate system, speculative capital inflows could be discouraged by opening the possibility of a subsequent depreciation.

On the budget, as the staff had pointed out, the actual deficit--with one exception--had been larger than projected in recent years, Mr. Posthumus observed. That pattern suggested that the authorities perhaps had to do more on the fiscal front--not to surpass their target, as he had originally suggested, but just to attain it. In light of the staff's comments, however, he wondered whether it would be feasible to implement additional measures during the fiscal year.

The Deputy Director of the Central Asia Department responded that, if the exchange rate were actually determined by market forces, it would indeed be inappropriate to engineer either an appreciation or depreciation of the rupee. However, the exchange rate was not at present market determined, as it was not allowed to move in line with market forces. That conclusion was

supported by the channeling of the recent surge in capital inflows into reserves, rather than into current account financing. In the present circumstances in India, a market-determined exchange rate would inevitably appreciate.

Mr. Autheman remarked that he disagreed with the staff's recommendations for handling the large capital inflows. The success of the authorities' present strategy of slow fiscal consolidation depended on a continuing increase in private investment financed by the absorption of capital inflows, including through direct foreign investment and the stock market. In an economy in which many prices were still distorted and, consequently, in which market fundamentals were difficult to assess, it did not seem prudent to take steps to discourage capital inflows. Furthermore, by letting the exchange rate appreciate, the profitability prospects of capital inflows would be reduced because of the bigger depreciation risk.

Mr. Evans said that he supported the staff on the exchange rate question. If sizable capital inflows were to continue, those market forces should be allowed to be reflected in both a nominal and real appreciation of the exchange rate. That judgment seemed to be confirmed by the fall in the real exchange rate over the past few years, which suggested that a small real appreciation would be easily sustainable.

On the budget, there seemed to be a real danger of missing the 6 percent fiscal deficit target for 1994/95, Mr. Evans added. Moreover, it was even possible that the 1994/95 deficit would be larger than the preceding year's. As Mr. Autheman had emphasized, such an outcome would seriously damage the authorities' credibility. In those circumstances, the Government's first priority should be to aim to improve--even if only modestly--on the announced goal of a 6 percent fiscal deficit.

Mr. Abbott commented that the data seemed to indicate that most of the capital inflows into India were in the form of portfolio investment, rather than "hot money." An appreciation of the exchange rate would have the effect of chilling those speculative inflows. At the same time, an appreciation would also facilitate the accommodating adjustment of the current account. If the authorities were not willing to allow a change in the exchange rate, the first-best choice would be to reduce the budgetary deficit, as that--through the central bank financing of the deficit--was the source of the monetary pressure.

A second-best way of accommodating the current account adjustment would be to continue liberalizing imports, which, as other speakers had mentioned, would also have a positive effect on the budget, Mr. Abbott suggested. However, as those actions were likely to be delayed at best--and to go in the wrong direction at worst--the tolerance of some appreciation would appear to be appropriate. The alternative--prolonging the attempts at sterilization--would lead to damaging consequences by feeding a reacceleration of inflation.

The Acting Chairman observed that Directors appeared to agree that, in the face of the rising capital inflows, reducing the fiscal deficit would be the first-best action that the authorities could take. A number of Directors had also emphasized the further liberalization of imports as a second-best action.

The Deputy Director of the Central Asia Department said that the scale of the capital inflows was at the root of the problem. Over the past two months, inflows had exceeded projections by $3 billion. If the inflows were to continue at that rate, an additional $18 billion would pour into the country over the next six months. Inflows of that magnitude could not be absorbed by increased investment, sterilization policy, or fiscal adjustment. In those circumstances, the authorities would have no choice but to allow the exchange rate to move with market forces. It should be emphasized, however, that the staff was not calling for an immediate, substantial exchange rate appreciation; it was merely suggesting that such an option should be kept in mind as events unfolded.

Mr. Kafka remarked that the use of capital restrictions as a temporary measure to control the inflows should also be considered.

The Deputy Director of the Central Asia Department responded that the use of capital restrictions could be objected to on the grounds that it would be sending the wrong kind of signal. Restricting the inflows--which, as one speaker had noted, could be traced largely to international portfolio investors--could create credibility problems. Rather than introducing restrictions on capital movements, it would be much more productive to remove all restrictions on the import side, especially on consumer goods.

The staff representative from the Central Asia Department added that the Government was using queuing devices--which could be regarded as a form of capital restriction--in issuing Indian company shares on the Euromarket, which accounted for a significant share of the capital inflows. However, there were limits to the extent to which the authorities could use such devices to slow down inflows without sending a signal that the liberalization process was being reversed. With respect to fiscal policy, as several speakers had suggested, a number of additional policy actions would probably have to be taken to reach the target of a fiscal deficit of 6 percent of GDP, the staff representative considered. For instance, fertilizer prices would have to be further increased by about 15-20 percent.

If the Government were to decide to consolidate the budget even further and surpass the fiscal deficit target, a number of additional actions could be taken, the staff representative continued. Administered prices could be raised further, and the pace of expanding the import license scheme for consumer goods could be accelerated. However, it should be noted in that respect that the recently announced trade liberalization measures would add only about .1 percent of GDP to revenues. On the expenditure side, spending could be kept below budgeted amounts, as had been done in the past--most notably, in 1991/92.

The authorities had not yet undertaken a comprehensive public sector review, encompassing tax, expenditure, and employment issues, the staff representative noted. The fact that the largest share of employment in the general government sector was at the level of the States was a major complication, in view of the difficult, but less transparent, financial situation of those entities. The Central Government was not a very large direct employer in India.

In late 1992, a joint commission of the Central Government and the States, including the governors of several key States, had been established to mobilize broad support for a review of the public sector, the staff representative recalled. The commission, referred to in India as the "Austerity Commission," had made a number of concrete recommendations to reduce the civil service wage bill, including by eliminating the cost of living mechanism, and to address the problems of the state-level public enterprises, particularly the electricity corporations.

Unfortunately, most of the recommendations of the Austerity Commission had not yet been implemented, the staff representative observed. The cost of living mechanism, for example, was still in effect. A few States had begun to take steps to improve the operation of the state electricity boards, including by adopting minimum tariffs, increasing their efficiency, and looking into greater private sector involvement.

With respect to the environment for foreign direct investment, steady improvement had been witnessed since the advent of liberalization measures in mid-1991, the staff representative commented. Many regulatory restrictions had gradually been eliminated, and the Foreign Exchange Regulations Act, which had formerly incorporated many exchange restriction elements, had been revised. The authorities had reduced discrimination against foreign-controlled companies by bringing their corporate tax rates much closer to domestic tax rates. Finally, foreign institutional investors had been given permission to participate in public sector asset sales. In general, the former controlling approach to foreign direct investment could be said to have been replaced by one characterized by encouragement and openness.

As a result, a large number of foreign direct investment applications were building up in the pipeline, the staff representative from the Central Asia Department concluded. At present, most of the foreign capital inflows were in the form of portfolio investment, including portfolio equity, with foreign direct investment accounting for only about $600 million of the total. However, the pipeline for new investments, especially in the oil, power, and other export-oriented sectors was getting quite full.

Mrs. Wagenhoefer made the following statement:

I would first like to recall that the Board had been very pleased in June 1993 to state that the balance of payments crisis

in India had ended and that good progress was being made in a number of fields.

Second, I note that after observing the worsening of the fiscal position in 1993/94, and in looking at the proposed budget of February 28, 1994, most speakers seem to be rather disappointed. We must ask ourselves whether there is anything still to be done on the part of the Indian authorities to improve the fiscal performance.

Third, it is good to see the reduction in the current deficit, even if it is in part due to slower growth and, therefore, slower import demand. Certainly, however, it is a welcome factor. In this context, it is interesting to note the huge inflow of capital and the questions arising therefrom. Two points could be emphasized in that connection. First, the staff is right in recommending what has to be done, starting with a fiscal tightening and a sharp acceleration of trade liberalization. Those actions should certainly be the first option. However, it may still be necessary, if the inflows continue, to focus attention on the exchange rate. I would join other speakers in saying that market forces should play a role in that respect. This comment, by the way, is directed not so much to the staff, which already shares that opinion, as to Mr. Geethakrishnan.

Second, India's large capital inflows are impressive. As capital markets reflect not only past developments but also expectations about future policy, these large inflows suggest that international financial markets might have a slightly more positive perception of India's fiscal and external policies than most of us around the table.

Mr. Kafka made the following statement:

India has in recent years achieved impressive gains. We have seen the steps taken to liberalize the economy and the resulting overt benefits: the expected narrowing in the current account deficit to 0.5 percent in light of the rise in exports by 21 percent in the first ten months of the current fiscal year; the relative stability of the exchange rate since the unification of the system in March 1993; the restoration of gross international reserves to the very comfortable level of five months of imports; and the positive--albeit low--rate of growth in GDP. The boldness of the steps taken and the difficulties faced deeply impress us.

The authorities' emphasis on growth objectives is understandable. There is, however, a fine balance to be struck in the mix of policies required to ensure that growth is not made ephemeral by higher inflation and its potential consequences with

respect to renewed external imbalances and a return of a stop-go cycle.

We would like to develop just two points. First, on the impact of continuing deficits on public debt, we concur with those speakers who emphasized that debt management should be seen as a critical factor in the overall program of fiscal consolidation. The interest burden, particularly on domestic debt, is expected to consume an increasingly large share of expenditure. This will be so as a result of both the rise in debt and the fact that its cost is to be increasingly subject to market pricing. The management of capital inflows could also have a negative effect on interest rate costs. Restrictions may have to be used even though they do not work for long. Obviously, however, the case for limiting fiscal deficits becomes even stronger.

Second, insofar as large capital inflows continue, India should seize the opportunity to privatize an increasing part of the state sector. Further measures to encourage private sector participation in the economy would also be timely. In this connection, we see an opportunity to deflect some of the potential risks that seem to be developing in the stock markets. An increasing pool of equity could reduce the risk of an asset price bubble and also reduce the spillover effect of inflated asset prices on other prices in the economy. To the extent that such portfolio investment could support new productive capacity or increase productivity, we would say, "all the better." We also welcome India's preparedness to consider early repurchases from the Fund.

Finally, we would like to commend the Indian authorities on their success to date. We trust that their measured strategy will provide the sustainable growth that we all seek.

Mr. Waterman made the following statement:

I would like to join other speakers in recognizing the very good set of papers prepared by the staff on India. As the main points that can be made about the Indian economic situation have already been well covered, I can be relatively brief.

There is no doubt that India has attained a remarkable achievement in recent years in its recovery from the 1991 crisis and implementation of the reform program. Nevertheless, most speakers have expressed some unease about recent developments, particularly on the budgetary side. We tend to go on ad nauseam about fiscal policy--for good reasons, however. In all countries, we know that fiscal policy is very important to overall economic performance; when applied incorrectly, it is very hard to correct.

Fiscal policy also has significant implications for monetary policy, even in those countries where the deficit is fully funded.

The reasons for concern on this front, therefore, are very well founded. As Mr. Geethakrishnan argues, there may be good cause for the current fiscal situation; however, the bottom line is that it seems to be unsustainable, except in the very short term, and runs the risk of undoing much of the good work accomplished since mid-1991. This morning's discussion is conveying to the Indian authorities the message that they need to reassess the balance that they are currently striking between the pain of reform and adjustment, on the one hand, and the risk of not moving fast enough, on the other.

Mr. Al-Jasser made the following statement:

The Indian authorities should be commended on their adjustment program, which was initiated in 1991. Confidence has been restored, inflation has been reduced, reserves have been rebuilt, and structural reform has been initiated. Despite continuing progress in many of these areas, developments in 1993/94 were unfortunately characterized by substantial slippage on the fiscal front and a rekindling of inflationary pressures.

Clearly, the sharp deterioration in the fiscal position in 1993/94 needs to be forcefully addressed. In this regard, the envisaged reduction in the fiscal deficit by 1.3 percent of GDP in 1994/95 is a step in the right direction. The authorities' emphasis on cutting current expenditures is also appropriate. Moreover, tax reform, with a view to reducing tax distortions and enhancing revenue elasticity, is encouraging and should bode well for the medium term. These measures notwithstanding, the budgeted 1994/95 fiscal deficit remains large and is projected to lead to a further rise in government debt. The expected increase in the level of indebtedness to more than 90 percent of GDP at end-1994/95 is particularly worrisome, as its high servicing requirements would reduce the Government's flexibility in cutting spending in the future. Indeed, Mr. Geethakrishnan notes in his helpful statement that the rise in interest expenditures is one of the main reasons for the relatively large fiscal deficit.

The authorities are therefore encouraged to strengthen the 1994/95 fiscal stance. Moreover, their intention to pursue further fiscal correction over the medium term should be formulated as soon as possible and be of significant magnitude. Delay in implementation of the needed fiscal adjustment will put greater pressure on monetary policy, reduce confidence, and stall economic growth.

Over the medium term, a substantially improved fiscal picture should facilitate the provision of adequate credit to the growing private sector without undermining the authorities' inflation targets. However, in the short run, continuation of the large capital inflows of the past few months could complicate the conduct of monetary policy. I agree with the staff that in addressing this issue, tighter fiscal policies and a modest appreciation of the exchange rate, coupled with accelerated liberalization of trade and elimination of restrictions on capital outflows, would be the preferred venue. Moreover, faster deregulation of interest rates and continued liberalization of the financial sector would also be important. In this connection, measures to ensure the soundness of the banking system are particularly relevant.

Turning to structural reform in other areas, the emphasis on promoting private sector investment and restructuring public sector enterprises remains most crucial. In this regard, steps to restructure the government-owned airlines and to promote private sector involvement in the hydrocarbon sector are important. However, as the staff rightly notes, reforms in a number of other areas and a more flexible exit policy are also needed.

I join other speakers in welcoming the authorities' intention to eliminate the remaining restrictions on payments and transfers for current international transactions at an early stage and to accept the obligations of Article VIII.

Extending his remarks, Mr. Al-Jasser noted that the Indian authorities knew better than others the value of the adjustment that they had put in place. He therefore joined previous speakers in urging them to persevere with their adjustment efforts. The sharp rise in foreign reserves served to underscore the value of those reforms.

He would be very happy to see the Fund's income decline as a result of India's early repurchase of its obligations, Mr. Al-Jasser added. Such a development--although perhaps not so welcome to the Treasurer's Department--would be an indication of the success of the Fund's dealings with that country.

As noted in the staff report, private sector liberalization efforts would be critical to the authorities' future success, Mr. Al-Jasser considered. More so than for other countries, perhaps, the hopes for a country of India's size--with its large population and unemployment problems--lay in invigorating the private sector.

Mr. Törnqvist made the following statement:

At this stage of the discussion, I can be brief. Let me first thank the staff for an excellent set of papers, which I

found very interesting. The policy recommendations are clear and pertinent. I support them strongly, including the apparently somewhat controversial one on exchange rate policy.

Second, I wish to join other speakers in commending the Indian authorities for what has been achieved in recent years. However, I share the concerns that have been expressed in the Board today, in particular about the serious fiscal slippage, which may endanger the progress achieved thus far.

On the structural side, the slow progress on tax reform and the improvement of tax administration, as well as on privatization and trade liberalization, is troubling. In addition, I wish to emphasize that financial sector reform is crucial for the Indian economy to function better, as several speakers have already pointed out.

On monetary policy, the very accommodative stance and the high degree of government deficit financing by the Reserve Bank of India are striking. To me, this indicates that the Reserve Bank has a low level of independence from the Government. If that is the case, it is a problem that needs to be attended to. I would appreciate comments from the staff on this matter.

Mr. Kaeser made the following statement:

We commend the Indian authorities for their efforts in dealing with their balance of payment problems and for the progress achieved. Over the fiscal years 1991/92 and 1992/93, fiscal imbalances were reduced. The tax system has been rationalized, and the trade regime has been simplified. The rupee has become convertible for current account transactions, balance of payment equilibrium has been restored, and international reserves are growing. We therefore share the staff's view that the remaining foreign exchange restrictions are unjustified and ought to be removed.

This chair is concerned by the strong increase in the fiscal deficit for 1993/94. Although shortfalls in customs duties and tariff cuts can be blamed for part of the widening, the presence of structural components is nevertheless worrisome. Expenditure overruns have been largely concentrated on subsidies. Interest payments on government borrowing have been growing steadily, accounting now for more than one third of current spending, and defense expenditure has been increased by 20 percent. Increased government borrowing will crowd out the private sector.

Political considerations have clearly been at work. Important regional elections will be held in the southern part of the country this year, and early general elections may also be

organized. Corporations have therefore received advantages. Farmers will continue to get subsidies for their fertilizers, and unions are happy because the budget does not deal with the closing of loss-making public enterprises. Maintaining political stability is obviously useful and necessary to carry out structural reforms, but this chair would like to point out the dangers of failing to adopt a strong fiscal stance.

The Government's expectations of reducing the burden of the fiscal deficit by growth-promoting measures may be deceived. Although tax reforms will encourage private sector activity, increasing government borrowing will crowd out private investment. Reserve requirements on the banking system will remain high, and directed credit will stay in place, leaving few resources left for the private sector.

Because monetary policy has accommodated part of this fiscal slippage, inflationary expectations have built up, as the steep yield curve tends to indicate. This development will further negatively affect private investment and growth.

In addition, important structural reforms have still to be completed. The need to reform labor laws has not been addressed. The inability for employers to dismiss redundant workers is often cited as a disincentive by potential investors. Companies may not expand production for fear of being burdened with excess labor in the future. Despite the booming stock market, little headway has been made in restructuring and privatizing large public enterprises. The trade regime should be further liberalized, the tax system restructured, and the financial sector strengthened.

A similar exercise has to be performed at the level of the States. Although the Central Government has no direct power over States' finances, efforts should be undertaken to make some progress in tackling fiscal problems, notably the inefficient tax systems, excessive wage bills, and large losses of the state-run electricity, transport, and irrigation enterprises.

Extending his remarks, Mr. Kaeser observed that the Indian authorities had managed to bring about an impressive economic turnaround since 1991, for which they had been warmly commended. However, the sharp increase of foreign direct and portfolio investment, which represented the reward of that policy, had apparently induced the authorities to become overconfident and switch their priority from economic stabilization to the stimulation of growth. As the monetary and fiscal consequences of that approach were not sustainable over the medium term, there was a serious risk that India's economic policy might fall into a damaging stop-and-go pattern.

The widening of the tax base was deemed to be an important part of the fiscal reform, Mr. Kaeser commented. In that context, his chair had

expressed some concern in 1992 because, even though about 10 percent of the population belonged to the middle class, less than 1 percent had been paying direct taxes. In his view, that situation represented a serious lack of wealth redistribution within the Indian society, as well as a lack of solidarity between the rich and poor. He wondered whether the situation had improved significantly in the interim, and whether the so-called presumptive scheme of taxation had played any role in that regard. In any event, the level of direct taxation in India was very low by international standards.

Mr. Zoccali made the following statement:

At this stage of the discussion, I will confine my comments to a few points for emphasis. First, the gains stemming from the program of structural transformation of the Indian economy during the past three years have indeed been impressive. Nevertheless, sustaining investor confidence will very much be predicated on the political will, as noted by Mr. Autheman and others, to maintain a climate of macroeconomic stability and to continue to tackle entrenched sectoral interests, so that the synergy of structural measures, as alluded to by Mr. Geethakrishnan in his helpful opening statement, may serve to unlock the economy's enormous potential.

Second, the recent slippages on the fiscal and inflationary fronts point to the desirability of an early return to the path of fiscal consolidation. An overall public sector deficit that is projected to reach almost 11 percent of GDP in 1993/94 poses a real danger of crowding out private sector activity. The strategy of resorting to even higher levels of public borrowing to stimulate recovery clearly risks aggravating the interest burden on the public debt, which already represents the major expenditure item in the budget, exceeding the combined appropriation for education, health, defense, and other social and general public services. This strategy also restricts the ability of the domestic financial system to intermediate resources efficiently, affecting the performance of private savings and investment.

Third, the emphasis by the staff on a comprehensive package of tax reforms to generate additional revenue is well placed. However, the efficacy of the tax collection effort is also dependent on the Government's perceived ability to keep reducing unproductive expenditure while minimizing the social costs of reform. Establishing greater clarity with respect to the projected distribution of aggregate public investment between basic infrastructure and that of loss-making enterprises is a starting point.

Fourth, the relationship between the Central Government and the States is deemed critical for the adjustment effort. The reference in the staff report to the fact that "the Central

Government has only limited direct leverage over States' financial policies" seems too passive a stance in light of the numerous subsidies and financial transfers from the Central Government to the States. Some comment from the staff or Mr. Geethakrishnan as to the medium-term strategy for improving the States' public finances would be welcomed.

Fifth, the remarkable growth of exports in 1993, particularly to nonmembers of the Council for Mutual Economic Assistance, and the reflow of private capital would suggest that further deregulation, particularly in the trade and payments area, could significantly enhance growth prospects. Some assessment of the budgetary cost, scope, and effectiveness of direct or indirect export incentives might also serve to clarify the sustainability of the export surge.

Finally, the policy of maintaining a stable nominal exchange rate by means of a substantial reserve accumulation has served to avoid an excessive real appreciation of the rupee. Nevertheless, some real appreciation has taken place, possibly impacting on competitiveness. In view of the current pace of deregulation and the size of the financial imbalance, we are not persuaded by the argument that a deliberate move to a policy that fosters more exchange rate uncertainty would have a stabilizing effect on expectations or enhance investment prospects. Thus, we agree with the staff and other speakers that a larger fiscal correction, coupled with other measures aimed at enhancing competitiveness through productivity growth, constitutes the most effective means for dealing with the risks of overheating associated with persistent capital inflows. As noted by Mr. Mirakhor, relying too much on sterilization would deprive the economy of the benefits of the inflows while maintaining the interest rate incentive and adding to the fiscal burden.

In closing, I would ask Mr. Geethakrishnan to convey to his Indian authorities the best wishes of this chair for continued success in the transformation of the economy.

Mr. Prader made the following statement:

We commend the Indian authorities' renewed efforts in 1992/93 to restore growth and external confidence and to implement structural adjustment measures in the areas of industrial policy, trade, and foreign investment. Despite this relatively consistent implementation of structural adjustment, however, much still remains to be accomplished.

In view of the difficult starting conditions for the stabilization measures implemented under the stand-by arrangement, India's recovery from its 1991 balance of payments crisis has been quite successful, as shown by the growth of net private capital inflows and the accumulation of a comfortable cushion of external reserves. Even with these significant improvements in the current and capital account, however, balance of payments viability still eludes India, mostly because of fiscal slippages.

The fiscal deficit remains the Achilles' heel of India's macroeconomic management. India's fiscal goals have not always prevailed over other objectives. Excluding exogenous shocks, future assessments of India's performance will depend on the authorities' ability, in a period of stagnating exports, to find sufficient public sector resources to meet the country's external financing requirements. The correction of India's payments imbalances has to compete with badly needed public investment in infrastructure; unless the right policy mix can be found, rising interest payments resulting from the ongoing financial market liberalization will further strain the government budget. Meanwhile, slow progress with tax reform and public enterprise restructuring is also creating public sector savings gaps that could crowd out private sector investment.

The following sequencing should be used to maintain an appropriate balancing of macroeconomic priorities. First, the stage should be set, through revenue mobilization and containment of current spending, for further deepening the structural reform effort. Second, deregulation of the financial markets should be continued by use of appropriately flexible monetary controls. Third, and finally, public sector resources need to be freed up to permit the private sector to take advantage of the new policy regime.

Mr. Mirakhor comes to the conclusion that India's economy has recently "exceeded the bounds of reasonable gradualism." While militant proponents of gradualism would probably have difficulty accepting any evidence of unreasonable gradualism, there is undeniably the problem that, in India's case, the imbalances have become much bigger than at the time of the previous Article IV consultation.

At the same time, the Government has announced its intention of making early repayments of a major part of its loan from the Fund. As a result, the idea of continuing its adjustment and reform efforts in the framework of a possible arrangement under the enhanced structural adjustment facility (ESAF) seems also to have become less relevant. While we must welcome from a purely financial standpoint early repayment of Fund credit and understand that this move may be justified by India's reserve and capital inflow situation, there are arguments for maintaining a more formal financial relationship with the Fund. Besides the question of whether these early repayments are not at least partly motivated by domestic political and financial opportunity-cost considerations, it might be argued that, in view of the large fiscal slippages, accelerating inflation, and uncertainties about external viability, the timing of the loosening of the relationship with the Fund is questionable; India seems now to have a greater need than it had a year ago for the additional discipline enforced by a formal Fund arrangement.

An arrangement would also help stop the slide into a stop-and-go pattern of economic policymaking. In my opinion, an arrangement under the ESAF would clearly demonstrate a longer-term commitment to structural reform, which would be reassuring to markets and donors alike. A premature separation from the Fund could lead to an off-again, on-again client relationship with the Fund that would drag on much longer in the end than an extension of the current arrangement into an ESAF. In any case, I would be interested in hearing from both the staff and Mr. Geethakrishnan about the role that they see for the Fund in the evolution of India's reform.

On the apparent discrepancy between the markets' optimistic view of India and the Board's more worried assessment, I should say--as the representative of a chair that was recently accused of market fundamentalism--that there is always the possibility of imperfect market reactions caused by delayed or incomplete information. For example, I understand that, in Bulgaria, despite the positive news of an imminent approval of a Fund-supported arrangement, the exchange rate suddenly plunged because the reporting of economic developments was delayed until it had been overtaken by events.

Mr. Mirakhor said that his remarks about gradualism should be interpreted in the light of his statement on India in the Board discussion of the previous year. At that time, it had been envisaged that India would reduce its fiscal deficit from some 6 percent of GDP to 4.5 percent. He had in that context argued for a more gradual reduction in the fiscal deficit to about 5.2 percent of GDP, with an accompanying change in composition in favor of infrastructure investment. Clearly, however, an increase in the

deficit from 4.5 percent of GDP to 7.5 exceeded the bounds of reasonable gradualism.

Ms. Patel made the following statement:

After two years of impressive achievements as a result of the prompt and decisive policy measures taken by the authorities to tackle the deteriorating economic situation--as witnessed by the notable turnaround in the economic and financial situation--the performance of the Indian economy during 1993/94 was mixed. Thus, while achievements in the external sector exceeded all expectations, as attested to by the remarkable buildup of the non-gold international reserves to the equivalent of seven months of imports, the performance on the fiscal front was rather disappointing, with a concomitant upsurge of inflationary pressures. Also, despite the good recovery in the agricultural sector, output did not increase, mainly because of the sluggishness of industrial production. Regarding the authorities' decision to repurchase all obligations to the Fund falling due in the new fiscal year, this is highly commendable; it will result in a substantial saving in charges.

Fiscal consolidation remains the centerpiece of the stabilization effort--even more so, in light of the slippage that occurred in 1993. Therefore, the wide range of measures proposed by the authorities to boost revenue and curtail expenditure is highly reassuring. There seems, however, to be a difference of opinion between the authorities and the staff on the pace and strength of the corrective measures. Although the staff urges adoption of a more rapid pace, the authorities--in consideration of the strength of the external sector and the substantial unutilized productive capacity--believe that a more gradual approach would better suit the purpose of economic recovery. Moreover, as emphasized by Mr. Geethakrishnan, the latter strategy could be the best under the present political circumstances to help muster the necessary support for the reform effort.

While these arguments have merit, I cannot but share the concern voiced by the staff about the need for a tighter fiscal policy, particularly in view of the sizable inflows of capital. Although the authorities have envisaged the use of monetary instruments to sterilize the impact of these inflows on monetary aggregates, a firmer fiscal stance will be required to avoid overburdening monetary policy.

Furthermore, the authorities may need to look for additional measures in the area of foreign exchange policy to complement their efforts on the monetary and fiscal fronts.

We would encourage the authorities to pursue more strongly the reform of the public enterprise sector. This will help reduce pressure on the budget and improve the efficiency of the enterprises themselves. In this respect, the authorities' intention to privatize some of the enterprises considered critical to the economy is noteworthy.

The authorities have made considerable efforts in their adjustment process. As a result, the economy has become increasingly outward oriented and guided by market forces. With the implementation of policy and structural measures, including those aimed at enhancing trade liberalization, the authorities have succeeded in boosting business confidence and creating an environment attractive to foreign investment. This will contribute significantly to the attainment of their primary goal of putting the economy on the path of sustainable growth, coupled with price stability.

I wish the authorities every success in their endeavors.

Mr. Fukui remarked that he wished to make two points about what was clearly the crucial issue in the Indian economy, namely, the appropriate response to the large volume of capital inflows. First, with respect to the possibility of utilizing foreign exchange controls, Japan's experiments in the early 1970s in setting negative interest rates for nonresidents and in applying global restrictions on foreign exchange banks' positions had demonstrated that it was more efficient to focus on preventing the entry of capital into a country, rather than on expelling capital that had already entered. Japan's experience during that period also underscored the need for an efficient foreign exchange banking system to cope with the inflows.

Second, as he had pointed out earlier, the large capital inflows into India were part of a phenomenon observed in many other Asian countries, including Sri Lanka, Bangladesh, and the Philippines, Mr. Fukui noted. The recession in Japan was critical in that respect, as the historically low interest rates in that country were prompting institutional investors to search for markets offering higher returns. However, it should be remembered that, as in the United States, domestic interest rates would rise again in Japan when the economy regained its forward momentum, and the impact of that development be factored into projections of capital inflows into India.

The Deputy Director of the Central Asia Department said that, with respect to the independence of the Reserve Bank of India, it was true that there were no legislative constraints on direct Reserve Bank credit to the Government. Moreover, the Central Government had the authority, at least in principle, to override the Reserve Bank's decisions.

At the same time, it should be emphasized that monetary policy had been conducted over the long term in a relatively conservative manner, the Deputy

Director of the Central Asia Department commented. The inflation rate had not been allowed to get out of hand. Also, the Reserve Bank had, in practice, been given sufficient autonomy in policymaking. In that context, the proposed phasing out of government access to ad hoc treasury bills was an important step. Ultimately, however, the primary focus should be on reducing the fiscal deficit, rather than on how it should be financed.

The staff representative from the Central Asia Department remarked that, as one speaker had pointed out, with the low number of payers of income tax in India, the tax system did not rely heavily on direct taxes as a source of revenue. However, the measures that had been taken in recent years, including the introduction of a presumptive scheme of taxation and the strengthening of tax administration, had begun to expand the number of taxpayers. Over the past year, for example, about 1 million new taxpayers had been added to the system, raising the total to 10 million. That increase, however, should be kept in perspective: India had a population of 860 million.

In the external sector, direct export subsidies had been eliminated several years previously, the staff representative from the Central Asia Department recalled. However, the recently announced expansion of the tradable import licensing arrangement could be regarded as a form of export incentive. Clearly, that initiative was very much a second-best approach to trade liberalization, but it should be remembered that its impact on export profitability would be negligible. Much more important were the exchange rate actions of the past several years, which had improved overall economic competitiveness and promoted the liberalization of trade.

The staff representative from the Policy Development and Review Department said that, with respect to the Fund's future relationship with India, the Article IV consultation process, including the recommendations contained in the Acting Chairman's summing up, would provide an opportunity to maintain an active dialogue. At present, the authorities had not requested arrangements under the ESAF; were such a request to emerge, of course, it would be evaluated on the basis of balance of payments need and strength of policies.

Mr. Geethakrishnan commented that he wished to thank the Directors for their analysis of the economic situation in India and the various suggestions that they had given, which he would relay to his authorities.

The perception--apparently held by some speakers--that the Indian Government had decided to slow the pace of reform was incorrect, Mr. Geethakrishnan stated. The authorities were fully committed to the reform process. As he had noted earlier, the authorities and the staff agreed fully on the reform package to be implemented; the differences between them were confined to questions of sequencing and timing, which were largely related to the need to obtain parliamentary approval of the package.

The privatization process served to illuminate the authorities' approach toward reform, Mr. Geethakrishnan continued. Naturally, they wished to restructure or close the loss-making enterprises as quickly as possible. As an example, however, Indian Airlines--the only airline company that serviced the entire country--had not yet been privatized. Nevertheless, the Government had opened air traffic to the private sector, and, within the past two years, that sector's market share in domestic air traffic had risen to about one third. It was even possible that, by the end of 1994, the private sector would have the dominant share of that market, which by most standards could be called a successful privatization.

Of course, many large energy-supplying enterprises, including utility companies and petroleum refineries, had already been privatized, Mr. Geethakrishnan added. Furthermore, the process by which one third of the market share of air traffic had been claimed by the private sector would undoubtedly be repeated on a larger scale in many other sectors of the economy, including the infrastructure. In those cases, however, in which investments of up to $1 billion might be involved, it was reasonable to allow from three to four years for completion of the privatization process.

The slippages in the fiscal deficit had been a cause for concern among Directors, Mr. Geethakrishnan noted. His authorities shared that concern and intended to return to the path of fiscal rectitude as soon as was possible. However, as he had emphasized in his opening statement, it was one thing to talk of a reduction in the fiscal deficit; it was another thing altogether to talk of a reduction in expenditure. The entire nonplanned expenditure of the Central Government of India, which was responsible for 900,000 people, was only 6.5 percent of GDP. That total included defense, civil service salaries, the so-called oil subsidies, transfers to the state, and support to other countries.

Therefore, the prospects for reducing nonplanned expenditure below 6.5 percent of GDP in 1994/95 were not good, Mr. Geethakrishnan remarked. In that connection, it should be pointed out that transfers to loss-making public sector enterprises, which were rightly criticized by Directors, amounted to only 0.08 percent of GDP.

The Government had been more successful in 1991/92 and 1992/93 in containing the fiscal deficit, Mr. Geethakrishnan recalled. However, the authorities at that time had been able to eliminate altogether the export subsidies, which had been a major part of the budget, because of the depreciation of the rupee.

The only remaining budget subsidies were for food and fertilizers, Mr. Geethakrishnan explained. Subsidies for imports of two of the three major fertilizer items--phosphate and potash--had been eliminated; however, support to farmers using those chemicals was still being provided.

Proponents of subsidy elimination were also calling for an end to the subsidization of nitrogen, or urea, the third major fertilizer item,

Mr. Geethakrishnan continued. Over the past fifty years, India had become self-sufficient in the production of urea and currently generated about 20 million tons a year. That unsung progress was instrumental in the country's increasing its agricultural output from 47 million tons at the time of independence to 185 millions at present. In those circumstances, it would be imprudent to throw an entire industry into disarray by hastily eliminating nitrogen subsidies; the process should be done in stages over a five- or ten-year period. In that respect, even the room for maneuver in implementing the staff's proposal to increase urea prices was limited.

It would be desirable if the share of nonplanned expenditure in GDP declined from the present level of 6.5 percent, Mr. Geethakrishnan considered. However, the projected expansion in government-provided health and education services in rural areas over the next ten years made that outcome unlikely. Certainly, the private sector could profitably set up hospitals and schools in metropolitan areas, where they could charge market prices. However, in a country of 600,000 villages, many of those services would continue to be provided by the Government outside the metropolitan area.

In those circumstances, the authorities would have to shift the emphasis from quantitative to qualitative expenditure, Mr. Geethakrishnan suggested. As speakers had rightly emphasized, state governments would have to contain fiscal deficits within approved limits, and their access to the Reserve Bank would have to be restricted. In general, government expenditure should become more productive. In that connection, unfortunately, interest expenditure, which had been rising by 1 percent of GDP a year for the past two years, would not begin to fall until 1995/96.

There was also little room to maneuver in reducing the 5 percentage points of GDP allocated for planned expenditure, Mr. Geethakrishnan commented. As reductions in that area would only cut into spending vitally needed for social, energy, and investment purposes, the authorities would have to concentrate their efforts on improving the quality of planned expenditure.

The solution to the authorities' fiscal problems lay in increasing revenue receipts, Mr. Geethakrishnan stated. The economy had been growing at a rate of 5-6 percent a year through 1990/91 but had not reached those levels subsequently. Revenue buoyancy had disappeared on account of the stagnant economy. Imports in 1993/94 in U.S. dollar terms had been lower than in 1990/91, and tax revenue as a proportion of GDP had fallen since the beginning of the reform process from 10.8 percent to less than 9 percent.

In those circumstances, one option at the Government's disposal was to delay the reductions in tariff rates, Mr. Geethakrishnan remarked. Tariffs had already been reduced substantially over the past three years, unavoidably lowering the total import tax levels. The authorities, however, had rightly decided not to adopt that option. In order to be

internationally competitive, India's high rates of taxation--both direct and indirect--would have to be reduced, albeit gradually.

It was envisaged that, with the expected rebound of economic growth to 5-6 percent in the year 1994/95, imports would increase, triggering, in turn, a surge in tax receipts, Mr. Geethakrishnan observed. In that respect, the decisions taken in January 1994 to decontrol administered prices, particularly petroleum product prices, would also bolster revenue performance. Those actions, together with the current trend in international crude oil prices, gave promise of a large surplus in the oil account, which would tend to push down the fiscal deficit. In that light, the goal of containing the fiscal deficit at 6 percent of GDP in 1994/95 was definitely within reach.

The concern expressed by speakers about the surge in capital inflows was valid, Mr. Geethakrishnan considered. The increase in inflows was putting pressure on prices, and the inflation rate was creeping toward double digits. However, the authorities, including central bank officials, agreed that, in the present circumstances, it was critical not to send the wrong signal while the Indian economy was attracting the confidence of the international community. A very delicate balance had to be maintained.

Furthermore, as Mr. Abbott had pointed out, most of the inflows were not in the form of cash, Mr. Geethakrishnan continued. About $600 million of the inflows were in the form of foreign direct investment, with financial institution investment comprising another $2.4 billion. Moreover, owing to the import compression of the past three years, the current account deficit had improved from over 3 percent in 1990/91 to less than 0.5 percent in 1993/94. As a result, foreign exchange reserves had risen dramatically, topping on the previous day the $15 billion mark.

It was expected that foreign direct investment would reach at least $2 billion in India in 1994/95, Mr. Geethakrishnan added. The anchor of foreign direct investment provided encouragement that, even if some measures were required to control cash inflows, the country's reserves position would continue to be very comfortable into 1995/96.

In the area of fiscal policy, his authorities agreed that defense expenditure had to be contained in the context of fiscal consolidation, Mr. Geethakrishnan commented. Accordingly, the Government had endeavored to pare defense expenditure to the minimum, so as to release maximum resources for development, poverty alleviation, and related social purposes. Thus, notwithstanding the 20 percent annual increase in the security provision, defense expenditure in 1994/95 would still be only 2.53 percent of GDP.

Moreover, the year-on-year increase of 20 percent was somewhat misleading, Mr. Geethakrishnan explained, as it largely reflected a failure to fully anticipate the impact of the sharp depreciation of the rupee on defense imports. In addition, the concern expressed by Mr. Mirakhor about the increase in India's defense expenditure should be set in the context of

the data presented in Working Paper 18 (3/9/94), which showed that, even after the proposed 1 percent reduction, Pakistan's defense expenditure as a proportion of GDP was still likely to be more than double that of India.

Finally, with respect to India's relationship with the Fund, the Government's decision to effect early repurchases of its obligations should not be interpreted as a desire to distance itself from that institution, Mr. Geethakrishnan stated. Of paramount importance in that respect was the Government's $15 billion in reserves, which had prompted it to issue instructions to all financial institutions, as well as to the public sector, to repay or prepay to the extent possible their high-cost borrowings. The decision to prepay the country's obligations to the Fund should thus be seen in that broader context.

India's relationship with the Fund continued to be totally cordial, Mr. Geethakrishnan added. His authorities had benefited considerably--and would continue to do so--from that institution's advice. Moreover, as India's Finance Minister, Mr. Singh, had said repeatedly, it had been an act of faith on the part of the Fund to have lent money to India in the summer of 1991, in view of its recent history of frequently changing governments. Nevertheless, the Fund had taken the decision to support India, for which his authorities would be forever grateful.

The Acting Chairman made the following summing up:

Executive Directors welcomed the impressive progress that had been made since 1991 in restoring external confidence, reducing inflation, and limiting the economic slowdown in the face of a severe external crisis. The rapid turnaround in the balance of payments has been remarkable, with international reserves rising to comfortable levels as a result of stronger export growth and large capital inflows. In addition, economic restructuring has begun to correct some of the long-standing distortions in domestic resource allocation.

Notwithstanding these positive developments and the strength of the external position, Directors expressed concern over several aspects of recent macroeconomic performance. They noted in particular the considerable widening of the budget deficit in 1993/94, which represented a risky slippage of fiscal policy. The persistence of high domestic interest rates and the sluggishness of the industrial recovery were also causes for concern, and the related surge in capital inflows had complicated monetary management and added to inflationary pressures.

In these circumstances, Directors stressed the urgency of reversing the slippages in fiscal policy, and they urged the authorities to return quickly and decisively to the path of fiscal adjustment. This would help to contain inflation, ensure that the public debt burden remains manageable, and facilitate the recovery

of private investment and growth. Directors noted that the fiscal stance embodied in the 1994/95 budget proposals would fall short of what was needed to ensure a sound budgetary position over the medium term and could be damaging to confidence. At any rate, additional supporting measures and considerably strengthened expenditure control would be needed to achieve the budget targets. Directors observed that the rapid growth of the public debt and the Government's interest bill in recent years had underscored the need to put fiscal policy on a more sustainable path. The quality of the fiscal adjustment would also be important, and greater attention should be given to raising revenue and containing current expenditure in order to allow room for increased investment in vital infrastructure and human resources. Several Directors stressed the need to streamline the public service and to exercise firmer control over public sector wages. In addition, some Directors regretted that a further reduction in defense spending had not been possible.

Directors welcomed the tax reforms envisaged in the 1994/95 budget, which should lay the basis for a less distortionary and more revenue-elastic tax system. They also welcomed steps to reduce further the import tariffs, to broaden coverage of the MODVAT system, to eliminate many exemptions, and to rationalize the tax structure. However, Directors stressed the importance of further reform to simplify the still complex rate structure and enhance the elasticity of the tax system. Directors also advocated action to replace quantitative restrictions on consumer goods imports with appropriate tariffs. In view of the importance of the finances of the States in the overall financial policy of India, the authorities were urged to redouble their efforts to secure a viable overall public sector financial strategy.

Directors noted that progress toward fiscal sustainability would help to alleviate pressures on domestic interest rates, which had played a role in attracting capital inflows. Lower interest rates would promote the recovery of private investment, facilitate progress in financial sector reform, and help to strengthen bank portfolios. Directors recommended that the remaining interest rate controls be eliminated and urged the authorities to reduce the scope of priority sector credit and other burdens on financial intermediation.

In order to manage the sizable private capital inflows, and to further enhance domestic efficiency, Directors strongly recommended accelerated liberalization of the trade and exchange system. They noted that the current strength of the balance of payments offered an excellent opportunity for rapid liberalization. Directors welcomed the recent reduction in import tariffs. They urged the authorities to eliminate the remaining restrictions on payments and transfers for current international

transactions, which would facilitate India's early acceptance of the obligations of Article VIII.

Directors noted that because fiscal adjustment and trade reform might prove insufficient to neutralize the effects of capital inflows, some exchange rate appreciation might be unavoidable; this could help to dampen inflation and discourage speculative capital inflows.

Directors welcomed recent indications that the authorities would pursue structural reforms in several sectors to improve efficiency, but they recommended a more vigorous approach to removing structural weaknesses, in order to encourage a rapid investment response by the private sector. Several Directors regretted the slow progress in restructuring and privatizing public enterprises, and in taking measures to increase flexibility in the markets for labor and land. They stressed that reforms in these areas were urgently need and would greatly increase the benefits of the more liberal trade and investment regime.

Directors welcomed India's intention to use the opportunity presented by the recent improvement in the balance of payments to make advance repurchases to the Fund. However, they cautioned that external viability was not yet assured, underscoring yet further the importance of continued fiscal and structural reform to ensure that the balance of payments remained strong.

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

The Executive Board took the following decision:

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

2. The restrictions on the making of payments and transfers for current international transactions described in EBS/94/16 are maintained by India in accordance with Article XIV, Section 2, except (i) restrictions arising under bilateral payments agreements with four Fund members, under the debt rescheduling agreement with the Russian Federation, and from the nonremittance of interest on nonresident nonrepatriable rupee deposit accounts, which are subject to approval under Article VIII, Section 2(a); and (ii) the multiple currency practice arising from exchange guarantees on interest payments on foreign currency nonresident accounts, which is subject to approval under Article VIII,

Sections 2(a) and 3. The Fund encourages India to remove the remaining restrictions maintained under Article XIV and urges elimination of the measures that are subject to Article VIII.

Decision No. 10638-(94/29), adopted
April 1, 1994

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

3. ALBANIA - 1994 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT

Executive Directors considered the staff report for the 1994 Article IV consultation with Albania and the midterm review under the first annual enhanced structural adjustment facility (ESAF) arrangement (EBS/94/39, 3/4/94; and Sup. 1, 3/31/94). They also had before them a background paper (SM/94/61, 3/11/94).

Mr. Martinez Oliva made the following statement:

In mid-1992, the Executive Board concluded the first Article IV consultation with Albania. At that time, Albania's newly elected Government had succeeded in overcoming the worst of the social disintegration that accompanied the collapse of the communist system, and was requesting Fund support, through a stand-by arrangement, for an ambitious program of macroeconomic stabilization and structural reform. The program faced exceptional risks and uncertainties owing to the difficult initial conditions and Albania's weak institutional base, and the Executive Board's summing up warned in particular of the danger of a slide into hyperinflation.

The results have certainly far exceeded initial expectations. After having declined by over half from 1990 to mid-1992, real GDP stabilized in the second half of 1992. This was followed in 1993 by a rapid expansion of economic activity in the agricultural, construction, transportation, and other service sectors, which led to an estimated increase of 11 percent in real GDP. This has been achieved against a background of continuous progress in reducing underlying inflation, which is now estimated at around 1 percent per month. International reserves have recovered from negligible levels to the equivalent of 2.3 months of imports of goods and nonfinancial services. Albania met all of the performance criteria under its stand-by arrangement with the Fund, which was replaced in July 1993 by an arrangement under the ESAF. Virtually all of the performance criteria and benchmarks under the ESAF have also been observed, and its key macroeconomic objectives have been exceeded.

It is much too early to call Albania's adjustment effort a success story. Albania is still the poorest country in Europe by far and seems likely to retain that distinction for some time to come. Despite noteworthy improvements in many structural areas, administrative capacity remains weak and a number of key institutions of a market economy are undeveloped. Data deficiencies hamper all aspects of policy development and monitoring. The external situation is also fragile, with a very large overhang of external payments arrears, a minuscule export base, and a continuing large requirement for concessional external assistance.

Notwithstanding the difficult challenges ahead, my authorities have reasons to be encouraged by the way in which events have unfolded thus far. They are acutely aware that the restoration of growth and the sharp improvement in inflation performance could not have been achieved in tandem or so rapidly without generous support from the international community, for which they are most grateful. They are also conscious of the benefits that have flowed from the comprehensiveness of the adjustment effort and consistent application of appropriate financial policies.

Despite the collapse of the public enterprise sector and the need for social safety net expenditures equivalent to about 15 percent of GDP, the fiscal deficit has declined steadily as a percentage of GDP. This has reflected, first and foremost, a strong commitment to the control of government spending and credit needs--facilitated by tax and social security reforms, the phasing out of budgetary subsidies, reductions of public employment, and structural reforms of the budget process such as the creation of a treasury management system and the development of a public investment program.

My Albanian authorities understand that further reductions of the public sector's domestic borrowing requirement are needed to pave the way for sustained growth of the private sector with low inflation. Because there is at the same time an urgent need to increase public investment, this will require an even greater improvement in public sector savings, as well as external support for infrastructure projects on appropriate terms. The scope for further compression of current expenditures is limited, underscoring the need to improve tax collections by broadening the tax base and strengthening tax and customs administration. Important complementary steps are also being taken to consolidate off-budget expenditures into the budget process and eliminate the use of credit guarantees. Deficiencies in the expenditure control process that contributed to exceeding the limit on fiscal expenditures at end-1993 are being remedied, and my authorities are hopeful that Executive Directors will support their request

for a waiver of the nonobservance of this limit and the limit on net domestic assets of the banking system.

Against the background of strong fiscal performance, program ceilings on the expansion of domestic credit have been observed continuously since mid-1992. Broad money has nevertheless expanded more rapidly than programmed, reflecting the robustness of economic activity and strong money demand. The economic program for 1994 aims to achieve a substantial deceleration of broad money growth.

Structural reforms in the financial sector have been particularly uneven, and my Albanian authorities intend to give this a very high priority in the coming year. They share the staff's assessment that "the negative effects of the underdeveloped financial system on economic activity are similar to those of the weak physical infrastructure, and must be remedied with equal urgency." While Albania has developed a reasonably well-functioning central bank, little has been done to reform the operations of the state-owned commercial banks, other than the Rural Credit Bank. Improvements in these remnants of the monobank system are likely to come slowly, and Albania is encouraging the entry of private and foreign financial institutions. In view of the condition of the financial system, credit controls must continue to play a central role in the conduct of monetary policy, but the Government intends to introduce treasury bills in the very near future as an important step toward an eventual shift to indirect monetary control.

The strong growth record in 1993 owes a great deal to early structural reforms, including the privatization of almost all agricultural land and most small and medium-sized public enterprises, price decontrol, and the extensive liberalization of the exchange and trade system. The supply response from the private sector in turn has played an important part in the reduction of inflationary pressures. Other factors in the inflation performance have been restraint over domestic credit expansion, the availability of imported goods and external assistance, and--especially in the early stages of the adjustment effort--incomes policy. In addition to deepening the reforms that have already been initiated, my authorities intend, during the coming year, to give a high priority to extending the privatization process to include most large public enterprises, improving the operations of the commercial banks, and putting in place important further legal and institutional underpinnings of a market economy.

Emergency assistance from the Group of Twenty-four industrial countries, as well as from other Fund members, played an essential part in halting the downturn in economic and social conditions. As the need for such assistance diminishes, the Government hopes

to be able to mobilize substantial external support for the public investment program. Building on an informal understanding with Paris Club creditors, bilateral agreements have been signed this month with two of the participating creditors, and the remainder are expected to be completed shortly. The Government is initiating payments due under the agreements, as well as those due on unrestructured obligations. Contacts are continuing with other bilateral creditors. Following a brief hiatus occasioned by changes in key economic positions and a reorganization of external debt negotiating responsibilities, Albania's debt negotiator has recently visited several major commercial creditors for preliminary discussions, with the aim of negotiating a debt buy-back operation on terms that could be supported by the IDA facility, consistent with Albania's limited debt servicing capacity and low per capita income.

My Albanian authorities also wish to underscore the very high value that they attach to the technical assistance provided by a wide variety of multilateral institutions and bilateral donors. This assistance has played--and must continue to play--a vital role in policy design and implementation.

I would like to express my authorities' appreciation for the support that the Fund has provided from the earliest stages of the adjustment effort.

Mr. Golriz made the following statement:

Following three years of falling production, Albania's GDP rebounded in 1993 and showed a growth rate of 11 percent owing to positive supply response to adjustment efforts. Other performance indicators, including inflation, point to highly encouraging developments. Factors contributing to Albania's remarkable performance are mainly its prudent financial policy, firm commitment to reforms, existence of a social safety net and favorable external environment.

Tight monetary policy has played a crucial role in reducing financial imbalances and stabilizing the economy. The Bank of Albania has been closely monitoring bank-by-bank credit ceilings while maintaining positive interest rates. Although broad money expanded more rapidly than programmed, owing to a sharp rise in GDP, developments in inflation and exchange rates suggest no sign of monetary overhang. We are encouraged to note from Mr. Martinez Oliva's statement that broad money will substantially decelerate in 1994.

Fiscal management has also been broadly satisfactory. Shortfalls in turnover tax revenues were partly offset by higher profit tax receipts. Weaknesses on the revenue side are excessive

tax exemptions and administrative difficulties. It is to be hoped that both issues will be addressed in the 1994 program. A value-added tax is to be introduced, with the collaboration of the Fund, and tax administration is to be improved. On the expenditure side, the developments were complicated mainly by a steep rise in public investments and interest payments, so that the overall deficit was 20 percent of GDP. Table 4 of the main report shows that the fiscal deficit will remain almost unchanged for the next two years, and we wonder whether it could not be lowered as the revenue collection, including receipts from privatization, is expected to improve.

Adjustment efforts continued energetically, including liberalization of prices and the trade and exchange rate system, as well as privatization of state-owned firms. On removing price distortions, a notable achievement was the liberalization of some sensitive items like wheat and bread whose prices were doubled. The footnote on page 9 of the main report shows that current market prices for bread are well below the ceiling set forth for state-owned bakeries.

The exchange rate was broadly stable after unification in July 1992, but appreciated by 25 percent in real terms during 1993. Appreciation of the exchange rate, as the staff points out, is perhaps due to overshooting in 1991-92, but it could also reflect, to some extent, confidence in the economy and inflows of capital. We fully share the staff's view that exchange rate movements should be closely monitored in view of developments relative to Albania's trading partners.

The privatization process has made good progress; in a short span of time--since July 1993--more than half of the 1,200 small and medium-sized firms have been privatized. We note that, in acquisitions of these firms, foreign investors are expected to pay a price at least 200 percent higher than any Albanian bidder. If these properties are not underpriced, the present policy would only discourage foreign investment, which does not seem to be the intention of the authorities.

A well-designed social safety net has reduced the human cost of transition and helped maintain the consensus in favor of reforms. An opinion poll of 18 East European countries conducted by the European Community earlier this year showed that "Albanians are the most optimistic that their economy is going in the right direction." The signs of confidence in the economy are reflected in several indicators. Increased national investment, especially in the private sector, is one example, and larger than expected contribution from remittances by Albanians abroad is another. It is quite encouraging to note from the staff report that "the rapid pace of price liberalization and privatization of state entities,

led to a shift in the distribution of income from state sector to rural market economy." Indeed, following several changes in the transition government, the new Administration has been successful in resuming public support and providing an environment of confidence in the economy. This has been achieved through the authorities' firm commitment to adjustments while the most vulnerable groups of the population were protected by a social safety net.

A favorable external environment has contributed to strengthening domestic efforts. In view of Albania's firm commitment to reforms, trading partners have been generous in relation to existing arrears. They should be encouraged to make more concessions in view of the country's good performance and the enormity of the tasks ahead. The international community has also been generous in providing technical assistance. Table 8 of the staff report shows that since 1991, some 50 missions and staff visits have been arranged by the Fund. We fully support this and future assistance, especially in the area of statistical organization and procedures.

Mr. Al-Tuwaijri made the following statement:

Albania's economic performance since Board approval of the first annual arrangement under the ESAF has exceeded all expectations. Real GDP growth was 11 percent in 1993, compared with a programmed 3.7 percent. Inflation has been lower than initially envisaged owing mostly to a strong domestic supply response, and the current account performance was much better than programmed. Furthermore, the price liberalization measures have now gone considerably beyond the initial program understandings. This impressive success attests to the authorities' determined and courageous efforts at reforming the economy under some very difficult circumstances.

These achievements notwithstanding, the medium-term external outlook remains fragile. The staff underscores this problem by noting that "external viability is not a realistic prospect without highly concessional external assistance to cover Albania's financing needs as well as a resolution of the debt overhang at a large discount." In the immediate term, continued restraint in fiscal and monetary policies is a precondition for ensuring the maintenance of Albania's impressive performance. However, the success of both policies hinges importantly on continued vigilance in the implementation of reforms, strengthening of measures relating to privatization, and the buildup of the administrative capacity of government. Needless to say, invigorating the private sector should be given the greatest of attention. I welcome the recent approval of the new draft Civil Code by the Council of Ministers.

Despite strong performance in the fiscal area, fiscal policy continues to have virtually no room for maneuver. I share the views of Mr. Martinez Oliva that the scope for further compression of current expenditures is limited. The burden of fiscal consolidation therefore lies on the revenue side of the budget. But, in addition to the large domestic imbalances and the urgent need to reduce the public sector borrowing requirement, the fiscal authorities also have to contend with various administrative and structural problems. It is clear from the papers before us that there is an urgent need to improve tax collection and customs administration, and to consolidate all off-budget expenditures into the budgetary process. To date, the authorities have made substantial improvements in expenditure monitoring. Considerable progress is equally needed in the other areas, if the authorities are to be able to finance the necessary expansion of social services and infrastructure investment.

The appropriately tight wage policy and the reorganization and restructuring of the civil service are important elements in maintaining fiscal discipline. In this context, I urge the authorities to exercise extreme caution in the area of incomes policy, which is one of the anchors of this program.

Monetary policy is another anchor of this program. Unfortunately, this is also the area where one of the performance criteria was not met, albeit for technical reasons. The staff notes that while the conduct of monetary policy has been broadly successful, inadequate data and reporting lags were responsible for the growth of broad money exceeding the program targets. This should not be surprising, in view of the rudimentary nature of the financial system and its institutions in Albania. Furthermore, the financial reforms envisaged under the program may well increase rather than decrease the risks associated with this anchor.

Against this background, and in view of the successful experience in the Baltic states, I wonder whether Albania would not be well served by a currency board arrangement. I understand that this may not be a viable option in the immediate future, in view of the credit needs of the public sector. However, as enterprise reform and privatization progress, credit needs will be reduced substantially, and Albania should be in a position to implement and benefit from such an arrangement. In particular, it would serve to further enhance investor confidence to complement the liberalization of foreign direct investment regulations. Moreover, it would provide a strong anchor against inflation. I would appreciate some comments from the staff on this matter.

In conclusion, Albania is moving faster in its reform efforts and performing better than initially expected. The authorities'

track record in implementing the reforms thus far is to be commended and lends great confidence to their ability to meet the challenges ahead. I support the proposed decisions and wish the authorities every success.

Mr. Wire made the following statement:

Like previous speakers today, we welcome the unexpectedly strong improvement in Albania's macroeconomic situation over the past year and good record under the initial phase of the ESAF. Capping this strong performance is the unexpected announcement that household energy prices will be liberalized today, nearly two years ahead of schedule--another welcome development.

A particularly encouraging element in the staff report is the evidence that Albania's efforts to stabilize the economy, privatize land and small businesses, and liberalize the exchange rate, foreign trade, and prices are beginning to evoke, as Mr. Al-Tuwaijri noted, a broad-based response from the private sector. This is exactly what is required to move the Albanian economy onto a sustainable growth path, depicted in the welcome upward revisions to the medium-term projections. More concretely, private sector activity is spurring visible improvements in living standards and, in the process, building popular support for a market-based economy. This point is well illustrated by the positive experience with bread price liberalization and the subsequent decline in bread prices. As Mr. Martinez Oliva says, maybe it is too early to deem Albania a success story, but as the reform effort gains speed, that day may not be far off. We welcome and commend Albania for the efforts that have brought it to this point, and we support the proposed decisions.

Nevertheless, the stabilization process is far from over: balance of payments viability remains elusive; the fiscal accounts remain in sizable deficit; and continuing large domestic financing requirements stand in the way of price stability. Moreover, the structural agenda is loaded with unfinished business. Some of these unaddressed structural issues, such as the need to reduce support for large state enterprises and public workers, directly endanger the stabilization effort by draining scarce public resources. Other issues raise stumbling blocks to the critically important growth prospects of the private sector. In general, the authorities seem well aware that a daunting agenda remains before them, but concerns remain with regard to policy implementation, administrative capacity, and, secondarily, the utilization of external assistance.

We are quite pleased with Albania's progress and agree with the insightful staff report, so I will just comment briefly on the

fiscal situation, problems in the financial sector, and impediments to privatization.

With the excellent macroeconomic performance in 1993, it is encouraging that single-digit inflation is now possible by 1996 and perhaps even sooner--an ambitious objective that we would strongly support. But price pressures remain, and with private activity vibrant, it is important that a tight fiscal policy be at the center of the program to reduce inflation further and avoid crowding out private sector growth. Although a more ambitious reduction in the domestic financing requirement would have been highly desirable in order to continue to capitalize on the progress made last year, the 1994 budget contains a number of important measures that move in the right direction. Full execution of the recently approved budget on the revenue side will be particularly critical, as fiscal policy seems likely to remain under considerable pressure on the spending side. In this regard, and in view of the importance of keeping wage and price pressures reined in, we have some reservations about the wisdom of a further wage increase later in the year; however, we see the proposed midsummer review of this and other expenditure issues as a reasonable approach.

In the monetary area, the process of building up the central bank and equipping it with appropriate weaponry seems to be moving ahead, albeit slowly, but we are concerned about the slow pace at which an adequate private banking and credit provision system is developing. The staff indicates that, in the context of crowding out, the large increase in private sector activity was financed through informal mechanisms and private capital inflows, neither of which forms the basis for the efficient financial intermediation needed to sustain and increase private sector growth over the medium to long term.

The near complete dependence on state-run banks is an already undesirable situation, and we are hardly reassured by indications that, after an earlier transfer of nonperforming assets off bank books, yet another round of portfolio problems seems to be emerging at these institutions. Firm adherence to the commitment to end government-guaranteed lending will be a critical aspect of the policy package necessary to prevent a further deterioration from occurring. At the same time, we completely agree with the staff that private banks and financial institutions are urgently needed, and would suggest that efforts to attract foreign participants offer at least part of the answer.

The biggest battle left in the reform effort still remains to be fought at the site of one of Albania's earlier successes: the reallocation of public assets to the private sector and the reduction of public claims on economic resources. The process of

agricultural privatization will not be complete until legislation is implemented that permits agrarian land to be sold or transferred. Similarly, the successful privatization of small and medium-sized enterprises has been undermined by restitution provisions that have impeded the ability of enterprise owners to gain free and clear title to nonagricultural land. We were thus disturbed to hear recently that the Parliament may have renewed, once again, these restitution provisions for an additional period of time.

More troubling than the continuation of these land-related issues has been the lack of inaction on large enterprises. The Enterprise Restructuring Agency (ERA), which was set up to facilitate this effort, was not used, and large enterprises received off-budget support and credits last year, a situation that cannot be allowed to continue. Rather than let these enterprises bleed the budget and the state banks, the authorities ought to get on with the task of liquidating nonviable enterprises and privatizing those that are viable. The plans articulated in the letter of intent represent a good first start, but remain to be fully articulated, much less implemented. We urge Albania to act with the same dispatch and enthusiasm on this issue as it demonstrated it is capable of with the lightning-quick action this week to liberalize energy prices.

As a final comment on privatization issues, pricing policies appear to discriminate against foreign investors, with the staff reporting that premiums of more than 200 percent are expected. While prices may still be relatively low in any case, such two-tier pricing undercuts the generally good signal that Albania is trying to send about its relative openness to foreign investment.

Turning to a broader topic of continued interest to this chair, we thought that the discussion of environmental issues in the report provided two nice examples--in agricultural privatization and firewood pricing--of how the Fund's market-oriented macroeconomic advice can play a strong complementary role in addressing critical environmental issues of long-term importance to the resource base and, hence, to the growth prospects of a member country.

In conclusion, Albania's recent success provides a heartening reminder of what a reform-minded government with a "can-do" attitude can accomplish, especially when it takes full advantage of the financial and technical assistance available from the Fund and the broader donor community. We hope that Albania's recent success and the key factors that have made it possible are noted and emulated by other transition economies facing key decision points in the reform process.

Mr. van der Kaaij made the following statement:

The economic performance of Albania continues to exceed expectations. Nevertheless, I share Mr. Martinez Oliva's observation that it is much too early to call Albania's adjustment effort now under way a success story. However, it could become one if the authorities continued to follow the path of stability-oriented policy in combination with structural reform, as is the case now.

In the staff appraisal, which I endorse, reference is made to Albania's limited administrative capacity and the regional security situation as putting the program at risk. Another risk is the fact that Albania will continue to rely heavily on foreign savings for many years to come. This calls for very cautious macroeconomic policies, as experiences in 1993 demonstrated. As regards fiscal policy, I note with satisfaction that progress has been made, in particular by bringing down the overall deficit. Nevertheless, the budget process itself remains weak, and so does tax administration. It is therefore worrisome that improvements in tax and customs administrations have fallen behind schedule, in particular as increased tax revenues are considered the driving force behind the expected substantial improvement of the budgetary position in the years ahead. In these circumstances, it seems realistic if not disappointing that the programmed tax revenue increases in 1994 are negligible--as they were in 1993. Therefore, I wholeheartedly support the conclusion that improvements in the tax and customs administration should be speeded up, and I am curious to hear from the staff what implications this has for the formulation of structural benchmarks and/or performance criteria under the second-year ESAF arrangement. In this context, I am a bit disappointed by the news that the placement of long-term advisors in tax and customs administration has been delayed further. But I can go along with the proposed benchmarks, also in view of the overall performance of Albania.

Especially as long as tax revenues lack a sustainable basis, caution should be applied to the level of expenditures, and, in particular, to current expenditures. An average increase in compensation for civil service employees of 30 percent can, therefore, only be justified if accompanied by a thorough review of the functioning of the public sector. According to Table 4 of the staff report, personnel expenditures are targeted to increase by 55 percent. I wonder how this figure can be reconciled with the earlier mentioned wage increase of 30 percent and with the assumption of a moderate streamlining of the public sector.

On monetary policy, I endorse the staff's recommendations. The fact that broad money growth in 1993 exceeded the targets

under the program because of a higher than expected increase in net foreign assets might be a complication. This overrun can partly be attributed to weaknesses in the financial infrastructure--which I hope will be addressed soon--but can also be considered a signal that Albania's policy has gained credibility.

On privatization, I note that half of all small and medium-sized enterprises have been privatized. No progress has been made in the privatization and reform of the large ones. I agree with the staff recommendation to step up the process by putting more emphasis on the speed of privatization than on collecting the proceeds stemming from it and on political considerations. I am interested to hear whether there is evidence that the rule that foreign investors have to pay at least 200 percent more than Albanian bidders has unnecessarily delayed privatization and the transfer of foreign know-how.

Regarding the larger enterprises, it is a reason for concern that the ERA did not begin operations in 1993. Part of the budgetary resources allocated to it might have shown up in the 1993 budget under the item Operations and Maintenance. It is, however, not clear whether these resources have been used for restructuring or closing supposedly sensitive enterprises. In this context, I would be interested in knowing what guarantees there are that ERA resources will really be used in 1994 to support privatization and restructuring.

The staff is rather positive in its assessment of the extent to which most state enterprises have been facing hard budget constraints in 1993. According to page 4 of the staff report, only a few enterprises received direct budgetary support, as commercial banks were cautious in extending credit to them, and the accumulation of interenterprise arrears came to a halt. However, after reading the report, which conveys the information that a substantial portion of the available credit has been channeled through the state-owned commercial banks to public enterprises, I have some doubt about the severity of the earlier mentioned hard budget constraints imposed on enterprises, especially as it is also noted in the report that state-owned commercial banks have again begun to experience high rates of overdue loans. The fact that these overdue loans are said to be related to credits extended to the private sector makes the situation even more puzzling. Staff comments would be welcome.

Mr. Törnqvist made the following statement:

The Albanian authorities and the Albanian people have made important and, in view of the conditions at the outset, very impressive progress in transforming their economy during the short period since the collapse of the old system. The targets under the programs, first under the stand-by arrangement and now under the ESAF, have generally been reached and, in important areas, exceeded. The nonobservance of the criteria under the ESAF appears to result more from technical reasons, including administrative weaknesses. There is, however, still a long and difficult way to go, as the somewhat uneven developments in the field of structural reforms show. In this respect, I am heartened by the clear recognition, as pointed out by Mr. Martinez Oliva in his statement, that it is much too early to call Albania's adjustment effort a success story. But let me add that it must be allowed to make the observation that it is a very promising start indeed.

Among the initial successes, I should like to especially commend the authorities for the swift redistribution and privatization of agricultural land and the way in which the elimination of bread subsidies was handled, which could be an example for a number of countries.

Looking ahead, I very much welcome the contingency plan for handling possible revenue shortfalls. This is certainly appropriate, in view of the uncertainty of the administrative capability of the tax and customs administration, and the supply response of the economy.

Much less successful has been the privatization of large enterprises. I welcome the high priority that this will now be given. I note from the staff report that, for these enterprises, one would rely primarily on foreign investors and partners, which seems most appropriate. I should like to ask the staff, however, what the experience has been thus far with the discrimination against foreign investors that appears to have been practiced with regard to the privatization of small and medium-sized enterprises. To what extent has this had a negative impact on the pace of the privatization process of these enterprises, and is it certain that no discrimination will take place in the sale of the large enterprises?

Let me make some observations on the need for technical assistance to Albania. Such assistance can certainly, if delivered and received efficiently, play a key role in facilitating the process of reform and development. For instance, the shortfall in public revenues was due mainly to administrative weaknesses. Moreover, these weaknesses and data problems

contributed to the nonobservance of two performance criteria for end-December 1993--the ceilings on fiscal expenditures and the net domestic assets of the banking system.

The areas of structural reform and institution building are also in need of continuous and extensive technical assistance. For example, the improvement of the tax and customs administration, the development of national statistics, as well as the establishment and supervision of the financial system, will require technical assistance of considerable magnitude for many years to come.

As the staff points out, the effectiveness of technical assistance depends on the timely availability of appropriate expertise, the degree of coordination among external agencies providing such assistance, and the receptiveness of the authorities to advice and their willingness to make use of technical assistance. It is very fortunate that the experience in Albania has been positive on all these points.

The experience from countries in my constituency indicates that a close follow-up on the implementation of the assistance provided and the training of counterparts--which in the case of Albania is most important--is important [suggest replace 'important' by 'critical'] and could be facilitated through use of long-term resident experts. I am pleased that the Fund has already in place two resident advisors to the Bank of Albania and that there are plans for the placement of resident experts in the customs and tax administration early in 1994. Especially when the bottleneck might largely be the ability of the authorities to digest and make practical use of the advice, the proximity and continuity that resident advisors and experts provide is most important.

Let me now turn to another crucial point for the sustainability of Albania's economic development, the large external financing requirement over the medium term. I am very glad to see that the country's external position improved more rapidly than programmed in 1993. The growth of exports by some 15 percent under the constraint of the uncertainty in this unstable geopolitical area is encouraging, even if this high figure in part might reflect improved recording techniques. At the same time, the composition of imports has changed toward more investment goods. Moreover, the relatively strong inflow of private investment capital points to general confidence in Albania's economic future.

Despite this relatively strong development, the external financing outlook remains fragile in the medium term. As the staff points out, in view of the extremely weak starting point,

the attainment of balance of payment viability will require substantial concessional support from external financing sources. While I would certainly hope that the funds needed to close the financing gap will be forthcoming, I nevertheless wonder whether there is not a case, as in the fiscal area, for drawing up a contingency plan for shortfalls in financing. However, there might be little to suggest as possible measures other than a slower buildup of reserves.

Albania has made a good start on the long road to a prospering market economy and deserves the continued help of the global community to make it to the finishing line. With these comments, I support the proposed decisions.

Mr. Desruelle made the following statement:

First, let me welcome the fact that we can have this discussion today after a very short delay. Let me also stress, like previous speakers, the positive performance of the Albanian economy under this first ESAF arrangement, with specific mention made of the strong output recovery and the better than expected decline in inflation.

In some ways, we are faced at the time of this review with a somewhat unusual situation: the final indicators of macroeconomic performance--output, prices, current account position--are favorable while the intermediate indicators--by which I mean the program's macroeconomic performance criteria--have registered some slippages.

The staff report clearly indicates the various causes behind both the positive developments and the slippages. On the positive side, one should count the authorities' efforts to limit expenditures, the strong rebound of agricultural output, and the growth in construction and services. We have here another demonstration of the rapid output effect that can result from privatization outside the industrial sector, and especially in the agricultural sector.

With regard to the slippages--and especially the slippage in the monetary target--it is equally clear that part of the blame is to be put on the difficulty of conducting macroeconomic policy, in view of the institutional weaknesses in the central bank and in the government ministries. One can, however, regret the slippage in the ceiling on budgetary expenditures, which reflects delays in the implementation of the strategy to deal with large enterprises. Nevertheless, overall, I fully support the request for waivers.

Turning to the future of the program--and, first, to its macroeconomic component--I understand that the principal share of

the burden of stabilization should be borne, as has been the case thus far, by fiscal and incomes policies. And I believe that this is the right course. Specifically, on fiscal policy, I fully agree with the staff that a combination of factors makes highly necessary a substantial improvement in fiscal revenue. In this respect, like Mr. van der Kaaij, I am somewhat concerned about the delay in the placement of long-term advisors, and I would welcome additional information on this delay. I also welcome the establishment of explicit contingency plans to deal with possible shortfalls in fiscal revenue. As for incomes policy, it remains essential, in view of the precarious state of public enterprises, and I welcome the target set for increasing the average wage rate increase for public enterprises.

On monetary policy and financial sector reform, the indications given in the report regarding the extreme weakness of the financial system seem to dictate this course of action: on the one hand, implementing structural reforms and strengthening financial institutions to put the financial system on a sound basis, and, on the other hand, exercising pragmatism in the conduct of monetary policy while the structural reforms are taking hold. On this latter point, strict and direct measures of control of banks' activities, as indicated in paragraph 19 of the memorandum of economic and financial policies, are fully warranted. This should not be a cause for worry as long as real interest rates remain positive; I would even say that, in view of the need for investment and growth, they showed remain positive but not too positive.

Beyond controlling monetary aggregates, monetary policy can also play a helpful role by facilitating a noninflationary domestic financing of the deficit. In this respect, I note that a major role of the Savings Bank is and should remain the mobilization of household deposits for government financing. I would welcome comments by the staff on the degree of inflationary impact of this method of financing and whether there is a case for trying to increase this source of domestic financing of the public deficit.

Agriculture is a major sector in Albania and, as seen this year, positive developments in that sector have had a major beneficial impact on the overall economy. Welcome structural reforms are being undertaken in this sector, such as with respect to land legislation. Still, in the memorandum of economic and financial policies, it is implied that, at best, a land market could exist in some parts of the country by the end of this year. I would therefore like to ask whether the staff sees a case for, and possibility of, speeding up reforms in this area.

Albania has received a substantial amount of technical assistance from many sources, including the Fund. This is fully appropriate in view of the presently limited administrative capacity of Albania and the need to develop it. In particular, there is little doubt that, in this case, intensive technical assistance is essential to help achieve the program's objectives. This is, I believe, an example to keep in mind when we are dealing with countries, in one region or another, with a similarly weak institutional structure.

With these comments, I fully support the proposed decisions.

Mrs. Wagenhoefer made the following statement:

The usual procedure in our Board discussions on countries in transition is to look at these countries in terms of objectives and achievements, in order to find out how far they have advanced on their way toward a market economy and to see what has yet to be done to get there. I fully agree with this forward-looking procedure, but sometimes it is also worthwhile to look back and to remember where those countries started from. This is particularly important in the case of Albania, and the staff reminds us very correctly of the country's starting point. For 50 years, as the staff report states,

> ...Albania maintained a rigid system of central planning and state economic control, accompanied by self-imposed isolation from the international community. All forms of private economic activity were actively discouraged.

Against this background, the progress Albania has made thus far is very impressive. Like other speakers, we commend the authorities for their courage and their outstanding track record. Decentralization and decontrol have courageously been promoted; the country is on its way to being integrated into the international community; and private economic activity is being actively encouraged. In macroeconomic terms, the fruits of these policies have recently been a much higher than the expected growth rate and, in the areas of inflation and the balance of payments, much better than programmed performances. What is important now is to maintain the momentum of reform and to address these structural and fiscal issues.

As I fully support the staff appraisal, let me comment only on two or three aspects of the economic policy for 1994. First, on fiscal policy, I agree with the staff and other speakers that substantial improvements in fiscal revenue performance are needed to finance social services and the necessary infrastructure

investment. In particular, improvements in tax administration and tax revenues should be given the highest priority.

With respect to government expenditure, we welcome the intention to make further progress in eliminating the remaining price subsidies. It is astonishing to see how courageous the authorities were in eliminating price subsidies, such as on bread and other foodstuffs, and the patience with which the population seems to have lived with these radical measures. It is also intended to reduce the number of civil service employees. Table 4 in the staff report indicates that personnel expenditure will be raised from 9.2 billion leks to 14.3 billion leks, about 55 percent; on the other hand, wages are to be increased by 30 percent. Perhaps the staff could enlighten us on this point.

On structural policies, the authorities must be commended for giving an outstanding example in the speed of privatization. Privatization of agriculture and retail shops is virtually complete, and substantial progress has also been made in privatizing transport, services, housing, and small and medium-sized enterprises. Unfortunately, thus far no substantial progress has been made in privatizing large enterprises. Owing to our own experience in the eastern part of Germany, we are well aware of the difficulties involved in restructuring and privatizing, especially in the case of large enterprises. However, we would encourage the authorities not to lose momentum in their efforts to privatize, especially in the oil, gas, and mining sectors.

As is mentioned in the background paper, the ERA was set up to restructure or close some of the large enterprises. As restructuring or closing down enterprises is certainly not a very profitable business--at least that is what our experience tells us--I wonder whether the staff can give an estimate of the expected expenditure of this agency, and whether that is already being integrated into the budget or will be shortly. What are the intentions of the authorities in this respect?

As my last point, I would like to follow up on what Mr. Wire said regarding reports that the framework for foreign direct investment might certainly be improved. Obviously, land cannot yet be bought by foreigners. Perhaps the staff could elaborate on this, as direct foreign investment is sorely needed in Albania.

The staff representative from the European I Department said that, unlike in many other countries, the early liberalization of all heating fuel and household electricity prices had been received in Albania with relative equanimity by the general public. That response could be attributed in large measure to the authorities' success in explaining to the public the objectives of the liberalization program. Undoubtedly, another contributing

factor was the substantial compensation that would be given to selected groups--as had been done previously in connection with the raising of bread prices--to cushion the social impact of the price increases. The current compensation was an investment well worth making, especially as the new pricing measures would still have a slightly positive to neutral impact on the budget.

With respect to the privatization of the small and medium-sized enterprises, the staff had emphasized to the authorities that the discrimination against foreign investors--in the form of auction prices at least 200 percent higher than Albanian bidders'--was counterproductive to development, the staff representative remarked. On the positive side, the authorities had indicated to representatives of multilateral financial institutions, including the Fund, that foreign direct investors and joint-venture partners would be welcomed on equal terms in the imminent privatization of the large enterprises.

Moreover, despite the Government's official policy, foreign investors had played a leading role in privatizing small and medium-sized enterprises, the staff representative added. The Government had not aggressively discouraged foreign investors from using Albanian citizens as "fronts" in purchasing those enterprises. Moreover, if, as was hoped, the recently announced introduction of greater price flexibility in the bidding process applied also to foreign investors, their participation in the privatization of small and medium-sized enterprises would be put on a firmer footing. With respect to the ERA, that agency would--if not complete--at least make headway in implementing its action plan in 1994, the staff representative commented. The Council of Ministers had agreed in principle to take the politically sensitive action of closing 31 big loss-making firms, which would entail separation costs of $18 million, and it was expected that an initial round of enterprise closures would be announced shortly. The full amount of $18 million had been included in the 1994 budget; however, as in 1993, provision had been made to adjust that amount downward in the event of a performance shortfall, so as to prevent diversions of unspent funds into other current expenditure categories.

Clearly, as one speaker had mentioned, the authorities' policy of imposing hard budget constraints on state enterprises had not been totally successful, the staff representative noted. Nevertheless, it should be pointed out that the amount of credit provided to public enterprises in 1993 had not exceeded the program assumptions, which was a surprisingly good outturn, as the banks were state owned.

Bad loans to the private sector had accounted for the increase in the state banks' nonperforming loans in 1993, the staff representative observed. External technical assistance would be used in 1994 to develop the credit assessment mechanisms needed to solve that problem.

In that connection, the prospects for a swift reform of the financial sector were not too encouraging, the staff representative added. The entry

of private banks into that sector--which could improve the situation dramatically--would take place only over time.

Meanwhile, the continued reliance on bank financing of the public sector deficit precluded the introduction of a currency board arrangement at present in Albania, the staff representative considered. Formal currency boards had been implemented successfully in the Baltic states--as had less formal, but similar, arrangements in other countries--and, with the expected reduction in demand for credit over the course of the ESAF-supported program, it was possible that it might become feasible to establish such a board at some point in the future. The experience of some Latin American countries also suggested that a strong domestic financial market would be needed to support a currency board, as the use of sterilization instruments would be necessary to enable the authorities to counter volatile movements in capital flows that threatened the domestic stabilization objectives.

As one speaker had suggested, the use of the Savings Bank's household deposits to finance the government deficit was in some ways similar to the placing, in other countries, of treasury bills in the nonfinancial sector, the staff representative explained. That Savings Bank practice might well have been a factor in the better than envisaged inflation performance in 1993, and it provided reason to believe that the inflation rate--adjusted for the pricing shock that had just occurred--might also be lower than the 1994 target. Deposits in the state banking system had grown substantially in 1993 because of both the strengthened confidence in the domestic economy's prospects and the high level of real interest rates, the staff representative added. If, however, the Savings Bank were to continue to place the bulk of its deposits with the Bank of Albania for onlending to the Government--instead of expanding its direct lending operations--rigidities might develop in the interest rate structure.

In the fiscal area, the staff representative remarked, the delay in implementing changes in tax and customs administration, including through the placement of resident experts in Albania, was a cause for concern. The delay was due mainly to the loss of policymaking momentum occasioned by the recent personnel changes in the Ministry of Finance. It was hoped that discussions later in the month with the new financial team, which had been closely reviewing the technical assistance proposal, would resolve the issue. In those circumstances, it was premature to speculate whether, as one speaker had suggested, a performance criterion should be attached to the tax and customs administration in the second-year arrangement under the ESAF.

Because of the delay in improving tax and customs administration, the goal of enhancing the revenue effort in 1994 was likely to prove elusive, the staff representative suggested. Accordingly, the agreed revenue contingency measures might need to be implemented in the second half of the year to attain the program's macroeconomic policy objectives.

On the expenditure side, as a couple of speakers had pointed out, government personnel spending was targeted to rise by more than 50 percent in 1994, the staff representative from the European I Department commented. One of the components of personnel expenditure, government payments to the Social Security Institute through the payroll bill, was largely responsible for that increase, as a shortfall in those payments at the end of 1993 had been compensated for in 1994.

Mr. Wang made the following statement:

The Albanian authorities are to be commended for their achievement in stabilizing the economy while introducing wide-ranging market-oriented reforms against a difficult economic and regional security background. Although there were a few slippages in observing performance criteria, the stronger than expected real GDP performance, reduced inflation, and favorable balance of payments developments suggest that the implementation of the program, supported by the Fund's ESAF arrangement, has been generally satisfactory. The slippages were mainly the result of technical problems and a lack of experience and expertise in market based practices; the authorities need more time to broaden their knowledge of the system and improve their statistical base. We have no difficulty in endorsing a waiver of the nonobservance of these performance criteria.

With regard to this year's economic objectives and policies, the authorities face a heavy agenda of deepening the reforms and sustaining the hard-won gains of the stabilization policy. Strengthened efforts to enhance institutions' administrative capacities should be made; this is critical not only for attaining the fiscal targets but also for maintaining macroeconomic stability when further price liberalization and financial reforms are introduced.

The authorities' plan to reduce public employment during 1994 is welcome. It will help them continue their strict incomes policy while providing adequate salary increases for public sector employees.

With regard to monetary policy management and the establishment of a modern banking system, the authorities are still in the early stages of financial reform. As the staff says in the report, "the negative effects of the underdeveloped financial system on economic activity are similar to those of the weak physical infrastructure." Bolder action from the authorities is needed. Continued assistance from the international financial institutions could play an important role in helping them create a modern central bank and domestic payments system.

The sweeping liberalization of exchange and trade restrictions has been impressive. We support the staff's suggestion on the direction of future moves with regard to other structural reforms, and we share the staff's disappointment on the slower pace of privatizing large enterprises. Poland's experience may serve as a useful reference. The Polish experience demonstrated how much the improved state-owned enterprises, building on their voluntary participation, had contributed to the overall output growth--in sharp contrast to some countries in transition engaged in overall privatization. Moveover, in the case of Albania, where the financial market and payments system are not yet fully functioning on a market basis, and where there is great pressure on the state budget, I wonder, at this stage, whether restructuring those enterprises toward independence while applying hard budget constraints might be more appropriate.

We support the proposed decisions.

Mr. Lvin made the following statement:

At the outset of my intervention, I would like to join previous speakers in commending Albania's authorities for their courage and determination in pursuing a profound economic transformation. In extremely unfavorable circumstances, which included the tearing down of traditional trade relations and routes, a weak administrative and institutional capacity, and an economy that was, on the whole, obsolete and distorted, they were able to begin implementing a comprehensive policy program.

The authorities' efforts, coupled with international financial and technical assistance, have begun to bear fruit. Indicators of 1993 economic developments are extremely impressive. Most negative trends have been arrested or reversed. Figures of GDP growth, even though that growth started from a historically very low level, are unique for an economy in transition. The rapid recovery of agricultural output and retail trade, following the swift privatization of land and small-scale enterprises, has substantially removed the issue of basic subsistence from the authorities' agenda, to the extent that they have met the serious difficulties encountered in distributing foreign food assistance and collecting relevant counterparts.

Probably the ultimate indicator of the real health of an economy is the rate of growth of private foreign investment. In 1993, this investment was 60 percent above the projected level in Albania, which reflected a real endorsement of the policies chosen.

However, industrial output remains severely depressed. I agree with the staff's view that the unsettled issue of the

enormous amount of short-term debt inherited from the previous regime has deprived state-owned enterprises of necessary inputs and has caused an output contraction that has reached a level far more severe than expected.

It is true that the decline in output of these enterprises exceeds the level of labor shedding and thus keeps productivity low and ever reduced. Nevertheless, the mere size of this labor shedding and open unemployment reflects a profound and welcome transformation on a microeconomic level. Another sign of a relative improvement in the situation of these enterprises may be seen in their ability to avoid a new surge in interenterprise arrears, which is commendable in itself. In this respect, the authorities' incomes policy seems quite reasonable, in that it links greater freedom in wage formation to an absence of major arrears, including to the budget. Could the staff provide us with more details about what is subject to regulation--the wage bill or the average salary--in the current wage regulation provisions that relate to state-owned enterprises?

Settlement of Albania's commercial indebtedness should substantially facilitate the recovery of industrial output, restore the viability of the large enterprises, and allow them once again to become a source of employment and tax revenues. Therefore, I urge the authorities to pay the utmost attention to this issue. For their part, creditors should demonstrate their understanding of the exceptional circumstances of the historical transformation that accompanied the process of Albania's debt accumulation and find ways to reduce the country's burden substantially. Once that debt situation is cleared, a currency board arrangement proposed by this chair during the previous discussion on Albania--and reiterated today by Mr. Al-Tuwaijri--may prove suitable.

The only certain way to revive an economy of Albania's size is to open it up to world markets as much as possible. Albania, once arguably the most closed country in the world, now enjoys very liberal foreign trade and exchange regulations. Such openness undoubtedly has resulted in a decline in some domestic industries that were unable to compete with foreign ones. At the same time, export-oriented activity has picked up in the private sector and is expected to continue to grow. In this respect, further steps to eliminate virtually all remaining barriers to foreign trade and current transactions, as envisaged in the authorities' program for 1994, are welcome.

In order to facilitate industrial recovery, modern institutions of financial intermediation should be fully in place. The staff in its background paper gives an impressive outline of the underdevelopment of the system of financial intermediation,

which is still in its infancy. The paper also mentions that no domestically owned private banks have been established thus far, and only two foreign ones have recently started operations.

At the same time, huge remittances from abroad have brought about a sharp increase in foreign currency holdings. Households are demonstrating familiarity with rational savings policies as they tend to build up their lek-denominated time deposits. The overall impression is that there is substantial room to expand banking activity, and a suitable policy response is becoming more imperative.

To this end, could the staff elaborate more on the issue of placing net foreign assets of commercial banks under central limits, as is mentioned in the staff report? What is the reason for doing so, except to ensure that official data will correspond to ill-defined benchmarks? In my view, the better than expected external position of commercial banks should be commended and further encouraged. Also, I wonder whether it is really necessary to maintain credit ceilings, particularly on a bank-by-bank basis. Continuation of the inappropriate practice of extending loans to doubtful borrowers may be related to the existence of these ceilings. At the same time, it looks as though the authorities are seeking to create a very unusual interbank market of credit ceilings instead of a more conventional fund market. Moreover, according to the memorandum of economic and financial policies, it is their intention to discriminate against the National Commercial Bank and prohibit it from recourse to new borrowing.

I am not certain that this is the right way. What is really needed is to speed up the ultimate separation of the balance sheets of the Bank of Albania and the National Commercial Bank of Albania and to resolve expeditiously other interbank claims. Pending such a settlement, a temporary hold on these old claims, along with the development of new interbank relations that are based on full transparency, may be an appropriate solution. New legislative steps, expected to be passed by the Parliament in 1994, aimed at improving the enforcement of civil contracts would be appropriate here. In addition, perhaps some decentralization of the banking sphere, established well before the possible privatization of that sphere and resulting in the creation of several more banks--more manageable, more responsible, and less politically strong--in place of the large state-owned ones should not be ruled out. Otherwise, in the absence of action, the need to carry out a large-scale bank-saving operation might become an unbearable burden on the still extremely weak budget.

The authorities' program is well designed, and I support the proposed decisions. I hope that the future year will bring new

success in strengthening economic reform, making growth sustainable.

Mr. Oya made the following statement:

I commend the authorities for having resolutely implemented the economic reform measures in the ESAF-supported program and having achieved substantial progress in both macroeconomic stabilization and structural reform.

It is regrettable that there were deviations with respect to quantitative performance criteria at the end of December 1993, relating to budgetary expenditures and net domestic assets of the banking system. However, the authorities have taken appropriate corrective measures in both areas, and I have no difficulty in supporting the staff's proposal to grant waivers for the nonobservance of the performance criteria.

Albania has been suffering from severe hardship. Its rigid system of central planning and unique self-imposed isolation from the international community, which lasted for more than forty years, have made it more difficult for Albania to move to a market economy and to integrate itself into the world economy.

In light of these circumstances, it is striking that the authorities have made substantial progress on both macroeconomic stabilization and structural reform although less than two years have passed since the commencement of economic reform. However, the challenges before the authorities are enormous and will require them to make further strenuous efforts.

I would like to make three comments on the challenges. First, I urge the authorities to give immediate priority to accelerating the privatization of large public enterprises. Although it is encouraging that the authorities have been broadly successful in imposing hard budget constraints on public enterprises, there is no denying that the continued existence of a large group of such enterprises could pose the risk of future pressure for large-scale financial support. As the staff rightly points out, the Government should focus without further delay on developing realistic plans and a clear timetable for privatizing the large enterprises.

Second, the main obstacles impeding the implementation of economic reform are the limited administrative capacity and the data deficiencies resulting therefrom. I believe that the utmost importance should be attached to resolving these problems as quickly as possible. Needless to say, technical assistance can play a major role in this. In this respect, it is impressive that the Fund has provided extensive technical assistance in various

fields. I found it surprising that the Legal Department has helped to prepare a draft of a Civil Code.

Third, I agree with the staff that the reorganization and downsizing of the civil service will be an essential part of the effort to free resources for high-priority expenditures. In order to implement this measure smoothly, the establishment of a well-targeted social safety net will be indispensable. Nevertheless, in case the authorities face difficulty in ensuring the maintenance of a capable civil service, a modest wage increase could be allowed, provided that it is accompanied by additional retrenchment measures, including downsizing.

With these remarks, I support the proposed decisions.

Mr. Hamilius made the following statement:

I would like to join other Directors in commending Albania's progress since the beginning of the program and its success in meeting most of the performance criteria. It is clear that the program is substantially on track, in terms of both macroeconomic stabilization and progress with structural reforms.

Basically, we accept most of the staff's recommendations. I can therefore limit myself to a brief comment on some aspects of monetary policy. The Albanian authorities face a dilemma common to transition countries. On the one hand, the Government's financing needs will remain high in the face of uncertainties about the availability of foreign assistance and foreign direct investment, while the needs of nongovernment sectors are also likely to increase. On the other hand, the inflation gains made thus far must be protected by containing the growth of monetary aggregates. I am therefore glad that the authorities have reaffirmed their commitment to reach positive real interest rates and limit to 29 percent the growth of broad money in 1994.

Although I welcome the introduction of new monetary policy instruments--most recently, the system of treasury bill auctions--the central bank credit ceiling will obviously remain the most effective monetary instrument, requiring strong support through the continuation of a strict incomes policy. I also concur with the staff that exchange rate developments are to be regarded as an essential indicator for the conduct of monetary policy.

In the structural area, I was pleased to learn from Mr. Martinez Oliva's opening statement that the Albanian authorities intend to give a high priority to financial sector reform in coming years. Reforming the financial sector is an urgent step toward effective and direct money control and the systematic elimination of nonperforming loans. At the same time,

priority should be given to enterprise restructuring efforts, as the large accumulation of interenterprise arrears and the possibility of extending credit support to loss-making enterprises could seriously hamper both financial and monetary adjustment.

The inevitable clearing of interenterprise arrears requires strict but flexible solutions. It will also be imperative to resist pressures to finance enterprises in financial difficulties. I was pleased to learn that the Government recently took steps to clear up nonperforming loans and halt the accumulation of new arrears to the state-owned commercial banks. Could the staff tell us what timetable to expect for addressing and settling involuntary interenterprise credits, and could it provide updated facts and figures about the quality of bank portfolios?

Although valuable initiatives are under way to improve and strengthen the functioning of the banking system, at present, some banks seem to perform only imperfectly even the basic banking functions. This raises concerns about how the forthcoming foreign assistance can be effectively allocated. There is strong doubt whether the Government will be able to do so. The issue is imminent because the Government intends to raise capital expenditure to 9 percent of GDP, reflecting higher foreign finance investment.

In conclusion, I support the proposed decisions and commend the steps Albania is taking to stabilize and restructure its economy. Much has been achieved, but much remains to be done. It is particularly encouraging that the authorities fully understand and accept the need to make sustained progress under a comprehensive medium-term plan of action.

Mr. Imashev made the following statement:

We are encouraged by the impressive upswing in economic performance in 1993 and the progress in structural reform under the current ESAF arrangement: buoyant GDP growth of 11 percent; a decrease in inflation from 237 percent in 1992 to 40 percent; an increase in official reserves from $30 million to $142 million; a decrease of the fiscal deficit by 4 1/2 percentage points of GDP; the restitution of 90 percent of arable land; and the privatization of more than half of the 1,200 small and medium-sized enterprises. These figures must, however, be regarded in relation to the earlier dismal situation. Against the background of a deteriorating governance record in a troublesome regional setting, and considering the large contributions of donors, we would caution against excessive optimism.

In order to consolidate the progress achieved thus far and set the basis for sustainable growth in the medium term, the

authorities should maintain and systematize their adjustment efforts. The stabilization results achieved thus far bear witness to a certain success in the central banking sphere, although serious data and reporting problems remain there, as well as elsewhere. Enhanced confidence nurtured by foreign exchange and trade liberalization, however, has already left a clear mark on the current account balance.

In contrast, the track record for structural reform is less solid. The lack of a consistent and firm legal framework, including a constitution, continues to be a major obstacle. It is difficult to understand how private ownership can be granted, secured, or used equitably and efficiently without the necessary legal basis. In practice, the allocation of 1 hectare of farmland per farm family will feed neither the farmer nor the towns, and some land transactions will clearly have to take place; there are reports that major foreign investment projects are stalled because of unresolved and legally unresolvable land disputes.

We share the staff's disappointment about the slow pace of privatization or liquidation of the large state enterprises. Although these enterprises apparently did not drain too many public resources last year, they still pose an undeniable risk of pressure for ample financial support.

With regard to the financial system, we also share the staff's sense of urgency for an accelerated buildup and strengthening. The same holds true, maybe in an even broader way, for public administration: its inadequacy is a root of the weak fiscal position, and substantial amounts of technical assistance are still needed. Moreover, the Administration's operational capacities are negatively affected by governance problems, and political infighting is too often hampering coordination between different agencies and administrative levels. This can pose significant obstacles for the adequate absorption of foreign assistance and foreign direct investment.

Although the outcome of Albania's balance of payments has been better than expected in 1993--and we commend this--its balance of payments position remains extremely fragile, owing to the low export capacity; financially, the country will, for the foreseeable future, have to continue to rely essentially on foreign aid and exceptional financing, as well as on remittances from its nationals abroad.

With these remarks, this chair approves the proposed decisions and wishes Albania further success in its reform efforts.

Ms. Langdon made the following statement:

At the time of Albania's first request for Fund resources, this chair was one of the "doubting Thomases," alluded to in Mr. Martinez Oliva's statement, that expressed substantial concern over Albania's weak institutional situation, the authorities' capacity to implement such a relatively ambitious program, and the subsequent exceptional risks that surrounded the program. While much remains to be done, as emphasized in the staff report and as stressed by previous speakers, the authorities' progress overall, in view of the initial starting conditions, has been quite impressive, if also somewhat surprising.

Looking ahead, our main concern centers on the collapse in the industrial sector, which appears to be the main source of the very high--even by regional standards--overall unemployment rate. While only receiving a passing reference in the staff report, persistent unemployment rates at this level, combined with continuing pressure to reduce budgetary expenditure on social reform, will undoubtedly undermine political support for reform. While the apparent hardening of budget constraints on state-owned enterprises is itself a welcome development, the failure to complement such action with activation of the ERA is disappointing, and we urge the authorities to move on this front expeditiously.

Another major difficulty of the reform program, as others have noted, is the lack of progress in privatizing medium- and large-scale state-owned enterprises. In their decentralized auction approach for small- and medium-scale state-owned enterprises, the authorities have applied the global requirement that the minimum acceptable auction price is the book value of the firm. In the current uncertain and recessionary environment in the industrial sector, it is unlikely that the market value of the state-owned enterprises is equal to the book value. Thus, local participation is likely to be minimal. Privatization of large-scale state-owned enterprises, a major component of 1994 structural adjustment efforts, has yet to even reach the initial stage of determining the method for privatization. A brief update from the staff on the status of work in this area by the World Bank would be appreciated.

Finally, developments in the banking sector give cause for some concern. Suffice it to say that government bailout of banks, as occurred in mid-1992, must be avoided.

With these remarks, we support the proposed decisions.

The staff representative from the European I Department said that, as one speaker had suggested, Poland's experience pointed to the improvement in

the performance of the enterprise sector that could occur in some cases if the work force were allowed to participate in the privatization process and if budgetary constraints were hardened. Indeed, the Albanian Government had tried that approach informally in 1992-93 with good results; many small public enterprises had been bought by employees who had channeled those assets into more productive uses. Even in the large state-owned enterprises, some workers were using the factory equipment to produce consumer goods rather than industrial goods--which, with the demise of the command economy system, no longer had a market. To that end, the authorities' focus would be on enlisting new entrepreneurial sources, where feasible, to manage the remaining viable large enterprises.

In the monetary area, the increase in the net foreign assets of commercial banks in 1993 had, owing to data constraints, been defined as part of the change in the net domestic assets of the banking system, the staff representative recalled. As a result, the program ceilings on net domestic assets had been exceeded in end-September and end-December 1993. The fact that the net foreign assets of the commercial banks at end-1993 had not yet been reported typified the data problems in that area. Work was being done to solve those problems however, and it was hoped that credit limits could be established more transparently in the second-year arrangement under the ESAF.

There were also shortcomings in the implementation of the bank-by-bank system of credit ceilings, the staff representative considered. However, that policy was not primarily responsible for the proliferation of nonperforming loans in the financial system. Moreover, the credit ceilings had provided the monetary authorities with an indispensable tool for controlling credit and, hence, money.

In fact, the major obstacle to effective lending in Albania--or, indeed, to any effort to transform the financial system, such as by increasing the number of institutions competing with each other--was the lack of trained managerial personnel, the staff representative explained. Only a handful of central bank employees--in addition to the foreign technical advisors--possessed the necessary administrative and technical expertise. As a result, the staff of the state-owned banks could not manage a commercial bank at present. Technical assistance was to be provided by the World Bank in that area.

The settling in mid-1993 of interenterprise arrears amounting to about 1.7 billion leks--out of total arrears of 5 billion leks--had been a onetime operation, the staff representative observed. The Government had announced at the time that it would not involve itself in any further settlement of arrears, so as not to create any moral hazard problems. That message had been reinforced when the authorities had not intervened to prevent creditor enterprises from swallowing a substantial portion of their claims on debtor enterprises.

It was difficult to pinpoint the exact amount of the nonperforming loans in the Albanian banking system, the staff representative remarked. The definition of a nonperforming loan varied from bank to bank; in some cases, the definition depended more on the bank's effort to collect the loan than on the borrower's willingness to repay it. Subject to those caveats, the data seemed to indicate that the percentage of nonperforming loans in the system was declining. For instance, the ratio of nonperforming loans in the Savings Bank had fallen from more than 30 percent at end-1993--the highest ratio in the banking system--to less than 20 percent in the first few months of 1994.

With respect to the commercial banks, the nonperforming loans had largely been caused by failures in collection, the staff representative from the European I Department added. However, the vigorous collection effort toward the end of 1993 had improved that situation. The loan performance of the Rural Credit Bank had also improved, in part because of a refinancing operation, but also because of technical assistance supplied by the World Bank to that institution.

In the fiscal area, the authorities' incomes policy was based on average salaries rather than the wage bill, the staff representative from the European I Department noted. That decision had been dictated in part by the difficulties encountered earlier in monitoring the growth of the labor force and, hence, that of the wage bill. With the improved techniques for tracking wage payments in the public enterprise sector, however, the authorities intended to implement an incomes policy based on the wage bill, so as to provide higher salaries to a smaller, more effective labor force.

The staff representative from the World Bank said that, since the beginning of the year, the World Bank had intensified its dialogue with the authorities, with a view to reaching agreement on a policy matrix that could be supported by a World Bank Enterprise and Financial Sector Adjustment Credit (EFSAC). A series of reforms in three areas would be encompassed under the EFSAC. First, the privatization of some state enterprises would be accelerated--not only the small and medium-sized companies but also, as many speakers had urged, the large loss-making companies--and other state enterprises would be restructured through the ERA.

Second, the reform of the banking sector would be continued, the staff representative observed, with the aim of hastening the Bank of Albania's transformation into an effective monetary authority. Also, thorough portfolio reviews of the state banks would be conducted in order to assess and limit the damage caused by nonperforming loans. Those reviews would be followed by the preparation of bank-by-bank restructuring plans.

Third, a legal framework--including well-defined bankruptcy and accounting laws--would be established for enterprises, and accounting procedures would be standardized for the banks, the staff representative from the World Bank stated. It was expected that, following the World Bank management's approval of the three-part package, the formal appraisal

mission could begin work in Tirana on April 11, 1994, with a view to submitting the EFSAC for consideration by World Bank Directors before end-June 1994.

Mr. Martinez Oliva said that he wished to thank the Board for the understanding and supportive atmosphere that had surrounded the comprehensive and stimulating discussion. He would be glad to convey the Directors' opinions and recommendations to the Albanian authorities, who, he was confident, would make the best use of them. He also wished to thank the staff for its excellent documents and top-level technical support.

After the current Government had taken office in April 1992, the active and courageous attitude of the authorities had brought some impressive transformations of the economy, Mr. Martinez Oliva recalled. The first Article IV consultation with Albania, in August 1992, had underscored that, after four decades of autocracy, economic centralization, and isolation from the rest of the world, the country had collapsed under the weight of an enormous foreign debt, severe price distortions, and an archaic productive structure. The staff had pointed out at the time that the risks of implementing reforms in Albania had been probably greater than the comparable risks in those countries that had been taking a more gradual approach to introducing market institutions and democracy.

Despite the difficult circumstances, the authorities had soundly reaffirmed their commitment to the transition process, Mr. Martinez Oliva continued. As his chair had pointed out in that Board discussion, the authorities had made a tough choice, and they had seen no chance of withdrawing from it.

In the following two years, Mr. Martinez Oliva noted, the authorities had been able to maintain their commitment to the ambitious and challenging adjustment effort, aided by the financial and technical assistance provided by multilateral institutions and bilateral donors. The review by the Board of Albania's performance under the stand-by arrangement in March 1993 had found that policy implementation had been broadly consistent with the program targets. The Board's subsequent discussion in July 1993 on Albania's request for an arrangement under the ESAF had confirmed that financial developments in Albania had continued to be in line with those underlying the program. All performance criteria under the stand-by arrangement had been met.

The present discussion had confirmed Directors' appreciation of the further steps taken by Albania in its transition to a market-oriented economy, Mr. Martinez Oliva considered. Nonetheless, the road to that important achievement was still long and full of risks and perils. The Albanian Government was moving with steady determination along a razor's edge, in a difficult equilibrium that continuously required the balancing of economic performance and social consensus. Any hesitation could prove to be very costly. The important policy developments that had taken place in Albania in recent days--as comprehensively described in Supplement 1 to the

staff report--were further evidence, should that be required, of the large, ongoing effort being undertaken by the Albanian authorities and their desire to continue building on their credibility.

On that point, Mr. Martinez Oliva added, a recent Policy Analysis and Assessment Paper (PPAA/94/3) had, in surveying the new literature on the political sustainability of economic reform, stated that "lack of credibility in stabilization and reform processes can lead to substantial costs and to the failure of the reforms themselves." According to that paper, in situations in which establishing the credibility of a government's commitment to reform was essential, some authors had suggested that the sustainability of reform might benefit from an initial overshooting, because that would enhance credibility by signaling the seriousness of the government's intention.

That description fit extremely well with the Albanian case, Mr. Martinez Oliva concluded. It illustrated the way in which the strong and determined commitment of the authorities in pursuing the adjustment process could become a major asset for a country that was able to make the best use of the generous financial support and active policy advice of the international community.

The Acting Chairman made the following summing up:

Executive Directors congratulated the Albanian authorities on the progress that had been made toward macroeconomic stabilization and structural reform. Directors considered these achievements particularly remarkable in light of the uncertainties in the region and the exceptionally difficult starting conditions in Albania, where the transition from central planning had been accompanied by civil disorder, virtual economic collapse, and a slide toward hyperinflation.

Directors were encouraged that the authorities' consistent application of a strategy of financial discipline, complemented by an effective incomes policy and accompanied by sweeping price, trade, and exchange rate liberalization and privatization, had contributed to rapid growth of private economic activity with a substantial reduction of inflation. The recent liberalization--some two years ahead of schedule--of prices for heating fuel and household electricity was another welcome example of Albania's progressive strategy. Directors noted, however, that the economic situation remained fragile, and they urged the authorities to move quickly to deepen structural reforms and to put in place the key institutions of a market economy.

Although the fiscal adjustment to date had been considerable, Directors emphasized the need to further increase public sector savings, in order to permit a higher level of investment while making further progress toward balance of payments viability and

reducing inflation. The effort to increase public sector savings called for further broadening and strengthening of the tax and customs administration. Directors also urged the authorities to phase out the remaining budgetary subsidies and limit the coverage of social assistance programs to the neediest groups.

Directors stressed the continued importance of incomes policy as a complementary anchor of the adjustment effort. In view of the low level of public salaries and the need to strengthen public administration, they noted the importance of conducting the planned civil service review as soon as possible. However, they cautioned against any relaxation of wage restraint in the civil service or state enterprises under the present circumstances.

Directors urged the authorities to remain vigilant in the conduct of monetary policy to avoid a resurgence of inflation. Directors also endorsed the substantially lower rate of expansion in broad money targeted for the coming year.

Directors welcomed efforts to improve the payments system, strengthen the operations of commercial banks, introduce new financial instruments, and encourage the entry of private financial institutions. They also stressed the importance of maintaining positive real interest rates, in order to mobilize financial resources, including remittances from abroad, in support of domestic investment.

Directors emphasized that structural reform remained the key to consolidating the economic achievements to date and setting Albania firmly on the path toward sustainable growth. They urged the authorities to quicken the pace of action in crucial areas, which, in addition to financial sector reform, included the privatization of large public enterprises, the clarification of land rights and establishment of a land market, and the putting in place of a legal framework to support and encourage private production and investment.

Directors underscored the crucial role that external assistance had played in supporting the authorities' program. They stressed, however, that Albania's balance of payments position remained precarious, and that continued external assistance on highly concessional terms would be essential to support Albania's reform program. In the circumstances, it might also be necessary for Albania to adjust to any shortfalls in external assistance that might arise. The role of technical assistance in strengthening administrative and implementation capacity was also noted, and Directors urged a continuation of such assistance by bilateral donors and multilateral institutions.

In short, Directors warmly encouraged the Albanian authorities to sustain their efforts and build on their hard-won gains. Promising results of a broad-based private sector response were beginning to be visible. The program for the period ahead was demanding, and decisive further progress needed to be made in critical structural reforms. Directors wished the authorities well and stressed the desirability of attracting foreign direct investment as an important source of non-debt-creating finance and market-oriented technology.

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

The Executive Board took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1994 Article XIV consultation with Albania, in the light of the 1994 Article IV consultation with Albania conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in EBS/94/39, Albania maintains exchange restrictions as evidenced by outstanding balances under inoperative bilateral payments agreements, in accordance with Article XIV, Section 2. The Fund encourages the authorities to eliminate these restrictions as soon as possible.

Decision No. 10639-(94/29), adopted
April 1, 1994

Enhanced Structural Adjustment Facility -
Review Under First Annual Arrangement

1. Albania has consulted with the Fund in accordance with paragraph 2(c) of the first annual arrangement under the enhanced structural adjustment facility (EBS/93/93, Sup. 2, 7/16/93, and Cor. 1, 2/24/94) and the final paragraph of the letter of the President of Albania dated June 15, 1993, attached to the arrangement.

2. a. The letter of the President of the Republic of Albania dated February 24, 1994 and the memorandum annexed thereto shall be attached to the first annual arrangement, and the letter dated June 15, 1993 and the memorandum annexed thereto shall be read as supplemented and modified by the letter of February 24, 1994 and its annexed memorandum.

b. Accordingly, the indicators referred to in paragraph 3(a) of the first annual arrangement shall include the benchmarks set out in Table 3 and Table 4 (Section II) of the memorandum attached to the letter dated February 24, 1994, as modified (EBS/94/39, Sup. 1, 3/31/94).

3. The Fund determines that the midterm review specified in paragraph 2(c) of the first annual arrangement has been completed, and that Albania may proceed to request the disbursement of the second loan under the first annual arrangement, notwithstanding the nonobservance of the quantitative performance criteria referred to in subparagraphs 2(a)(i) and 2(a)(iii) of the first annual arrangement.

Decision No. 10640-(94/29), adopted
April 1, 1994

4. PRECAUTIONARY BALANCES

Executive Directors considered a paper on the Fund's precautionary balances (EBS/94/53, 3/11/94).

Mr. Prader made the following statement:

While providing interesting new information, the follow-up paper to the June 1993 discussion (EBM/93/86, 6/21/93) only reconfirms this chair in the position that it then took.

One merit of the staff's documentation is to show that by all standards, including the methods and criteria for risk evaluation used by government credit agencies and multilateral development banks (MDBs), it can justifiably be claimed that the Fund's approach to building up precautionary balances is indeed overcautious and errs on the side of safety. In fact, the information provided by Fund members with respect to their provisioning against sovereign risks suggests that hardly any government credit agency holds any reserves, not to mention reserves comparable to the Fund's high standards. Even the availability of sophisticated risk-assessment schemes does not seem to have made any significant economic difference, but perhaps it had a calming effect on the nerves of the policymakers through the sometimes illusory sense of security given by elaborate, quantified approaches. Nevertheless, it might be interesting to obtain specific figures from the staff on the level of reserves held by government agencies of some major creditor countries, in relation to total credit extended by that country and in relation to the Fund's reserve levels.

The level of the Fund's reserves is adequate, and if change were contemplated, it would be justified to accumulate precautionary balances at a rate lower than the current extremely high one. Between the extremes of those who wish to raise the Fund's level of reserves and the rate of reserve accumulation beyond what we have considered reasonable to date, and others who would like to see lower reserves, we could be perfectly happy with a reserve target of 3-5 percent of total credit, which the Fund, in any event, over recent years has exceeded by huge margins. In addition, any serious discussion of the adequacy of the Fund's precautionary balances should include the Fund's gold holdings, which, in view of their undervaluation, represent a substantial hidden asset and thus a massive protection of the Fund's capital. Taken together, the various elements of prudent Fund policy, namely, reserve accumulation, undervaluation of assets, the strengthened arrears strategy, and prudent policy recommendations, should more than suffice to protect the Fund against any residual risk. In view of the Fund's comfortable reserve cushions, the real origin of these discussions on Fund reserving seems to be the second thoughts of some members about the value of the Fund's conditionality.

The staff paper also reconfirms our earlier suspicion that attempts to devise more objective measures of Fund risk and more objective criteria for the Fund's reserving policy are doomed to founder in contention because they themselves can only be based on subjective and ultimately arbitrary judgments. For this reason, all alternatives to the present approach are fraught with major problems and cannot be considered satisfactory. This generally negative view applies equally to the risk index approach, to the approach of determining country-related precautionary balances, and to the approach of establishing precautionary balances in relation to total credit outstanding or in relation to credit outstanding to members not in arrears to the Fund. In view of the present low level of utilization of Fund credit, the latter approach would even suggest stopping the increase in reserves. As a general principle, the Board should not be biased in the direction of raising reserves but should also be willing, when the opportunity arises, to accept a lowering of reserves.

During our Board retreat, the discussion on precautionary balances was finally placed, both intuitively and officially, in its proper context, which is the perception of increased risk owing to lending to the countries of the former Soviet Union (FSU). If the possibility of an additional regional concentration of lending with the potential for renewing the arrears problem of the 1980s is the major issue, then all efforts to produce supposedly more objective risk evaluations would have to be directed toward this particular group, for instance by constructing a risk index for these countries or by setting

precautionary balances in relation to credit extended to this particular group of countries.

A number of questions would still arise. First, the risk associated with these countries would have been identified on the basis of prior subjective judgments and not on the basis of some quantitative risk evaluation. Second, the actions of identifying this risk group and subsequently addressing its risk, presumably via larger precautionary balances, could create problems of moral hazard: it could send a signal to these borrowers that these loans do not need to be repaid because protection has been provided by increasing the reserves of the lending institution. Third, who would pay for the higher reserves? Would the borrowers from that region have to pay in the form of higher risk premiums, or would the cost be shared somehow between the creditor and debtor countries at large?

My authorities are therefore not prepared to endorse any reserving policy of the Fund that is based on locating particular risk groups of the Fund and building up reserves for lending to these groups in advance. In cases where a particular lending risk is perceived, there are other approaches besides the alternatives mentioned earlier. One option would be to not lend money if there is a perception of too high a risk. This option would probably be rejected by those who want the Fund to be relevant at all times and under all circumstances. The other option is to establish a particular facility for risky lending, funded and protected by resources outside the General Resources Account (GRA). This approach would avoid all the unpleasant side effects attached to larger precautionary balances, such as burden-sharing discussions, rate of charge increases and the lowering of the rate of remuneration.

Let me be the first to admit that it may be unfair, not to say difficult, to identify such risky countries even if we had various reliable quantitative indicators and measures. Certainly there are several problem countries of the 1980s, for which hope was almost given up at the time, that have since achieved a miraculous and completely unexpected turnaround. Placing them in such a group then would probably have made their economic recovery and reacceptance in the markets much more difficult.

By the same token, I believe that any quasi-scientific effort to protect the Fund from the regional loan concentration resulting from FSU lending, by holding even higher levels of reserves than the Fund already has, could be counterproductive by leading to wrong conclusions not only in the recipient countries, but also in the markets, in the Fund, and in the Fund members contributing through the operational budget. The recipient countries might be tempted to implement unsound policies. The markets would

automatically be confirmed in their negative views of these countries. The Board might become less prudent in its lending decisions, and those Fund members that already voice suspicion about the risk of Fund lending might become less willing to participate in the operational budget.

As indicated earlier, I am also skeptical about an approach that would relegate risk assessment completely to the annual review of the adequacy of the Fund's precautionary balances, whether this is based on an assessment of the credit outstanding to the larger users of Fund credit--for example, those using over SDR 200 million--or perhaps on a variable proportion of total Fund credit outstanding. This approach seems likely to arouse controversy in either form, even if the risk assessment were presented only in aggregate form. If anything, such an assessment would display inconsistencies in the Board's decision-making process. The Board would in effect excuse itself from making judgments on the prudence of its decisions by relying on the prima facie safeguard of a later appraisal by the staff, which would more or less mechanically apply higher reserve standards to larger loans or a certain percentage of loans.

If the idea behind our reserving discussion is to increase the Board's and the staff's awareness of the risk of Fund lending, it would be more logical to make a risk assessment each time the Board approves a Fund-supported program and to set each loan approval in the perspective of its impact on total Fund risk. Perhaps this risk exercise, which would go beyond our present capacity to repay references, should be continued at later program reviews and consultations with program countries, because the real risk for the Fund might be greater at a later stage than at the time of approval. It is those assessments by the Board that could then form the basis of our annual review of the adequacy of the Fund's precautionary balances.

On balance, my preference is to continue our successful and pragmatic approach of determining the adequacy of the Fund's precautionary balances in the context of the Fund's income position, and to avoid any direct or automatic link between the level of precautionary balances and the Fund's outstanding credit. In other words, Conclusion F is this chair's choice.

Extending his remarks, Mr. Prader said that, although the discussion on establishing precautionary balances in the Fund in 1987 had been very painful, a consensus had formed that, because of the special character of the Fund, care would have to be taken to avoid the impression of provisioning, as outright provisioning would change the character of the institution. For that reason, he was strongly disinclined to support proposals that would define the Fund's precautionary balances as a

proportion of credit outstanding. The present judgmental approach of determining reserves was sufficiently flexible and conservative.

It seemed odd to be having a new discussion on precautionary balances after the obvious success of the arrears strategy, Mr. Prader considered. The present problems of the Fund did not lie in the size of its precautionary balances, but in developments that tested the Fund's operational approach to the limits and were perhaps beyond what the Fund could reasonably be expected to achieve. In that sense, the current discussion was perhaps a distraction from the real issue.

Mr. Kaeser made the following statement:

> Since the strengthened cooperative strategy has been established, the Fund has proved to be fairly successful in dealing with countries that have protracted arrears toward the Fund. Since then, only two members have incurred protracted arrears and six of the eleven countries that had overdue obligations to the Fund at end 1989 have settled their arrears. Even though it might be true that to some extent this development can be explained by the comparatively good economic performance of many developing countries, the strengthened cooperative strategy seems to be effective in lowering the Fund's risk against protracted arrears.
>
> Viewing the risk related to countries with protracted arrears, the Fund has achieved the fixed target, namely to cover all outstanding credits to them by precautionary balances. On January 31, 1994, the credits outstanding to these countries amounted to SDR 1,782 million, and the precautionary balances--reserves and SCA 1--amounted to SDR 2,231 million.
>
> Optimists may argue that, with the extended capacity-to-repay analysis of the staff and with a shorter reaction time by the Fund in case new protracted arrears occur, there is no need to strengthen the Fund's policy on precautionary balances. However, too much optimism may be dangerous in financial matters. Commercial banks had this experience in the aftermath of the international debt crises and following the last asset price deflation in several industrial countries. We want therefore to plead in favor of substantial reserves against unforeseen risks and would like the Fund to adopt a prudent attitude toward the risk on credits extended to members still current in payments to the Fund.
>
> Experience shows that good loans can become bad ones in a rather short time. It might also be dangerous to set too high hopes on the preferred creditor status of the Fund; it could well happen that not all Fund debtors are ready to accept this status in the future, as it was the case in the past. We see an

increasing risk in the growing orientation of the ordinary Fund resources toward specific types of countries, such as the CFA franc zone countries in the aftermath of the devaluation or the countries in transition. As we mentioned in the discussion on precautionary balances in June 1993, we fear that credits given under the systemic transformation facility bear higher risks than credits under the stand-by arrangement and the extended fund facility. The Fund still has too little experience with countries in transition, and, furthermore, we do not yet really know if all other countries that adopted adjustment programs are now on a path of sustainable growth and macroeconomic balance. The countries in transition as well as the developing countries are generally in a phase of rapid social, cultural, and political reconstruction. In such a situation, we cannot exclude a scenario by which in several countries this delicate process may suffer a setback caused by economic, social or political turmoil which could make rather difficult to face their financial obligations to the Fund.

We agree that the best way to reduce the risk of arrears is to conclude appropriate adjustment programs. Social security nets may prove to be very valuable for the financial health of the Fund as they increase social and political stability, and, therefore, the probability that adjustment may be sustainable. We also agree that the building up of precautionary balances should continue, and should not only cover the outstanding credits to countries which have protracted arrears toward the Fund.

However, what is the appropriate quantity of Fund reserves? The very useful staff analysis shows that we can build little upon the experience of governmental agencies, commercial banks, or the other main international financial institutions. The staff proposes several alternatives in order to estimate an appropriate level of precautionary balances. We are not in favor of determining this level through analyzing the individual countries' credit risks. First, there are too many assumptions to be made. Second, we see huge problems concerning the confidentiality of data collected in countries' risk analysis. Third, such an analysis cannot protect us against changing conditions in member countries using Fund resources; as we said before, good loans can rapidly become bad ones. Fourth, the limited capacity of the Fund's personal resources would be too strongly bound by this type of time consuming analysis.

We have little confidence in risk indices. We share the staff's judgment that these indices are too arbitrary, and not able to indicate a desirable level of precautionary balances. Finally, we believe that the best way to define the adequate level of reserves might be to establish a relationship between precautionary balances and total credit outstanding. We believe that the growth of precautionary balances should correspond in

percentage terms to the projected growth of overall outstanding credits.

Mr. Obame said that he wished to take issue with Mr. Kaeser's suggestion that the increased use of the Fund's ordinary resources by the CFA franc zone countries represented an unusually serious risk to the Fund. Admittedly, any lending operation involved a degree of risk; nevertheless, there was no basis for singling out the members of the CFA franc zone as high-risk recipients of Fund resources. The recent devaluation of the CFA franc, which had broadened the scope of adjustment in those countries, as well as the measures that would be implemented under the Fund-supported programs, should improve substantially the prospects of the CFA franc zone countries.

As Mr. Kaeser knew well, the Board had recently concluded that the risks to the Fund posed by those programs were minimal and well within the norm applied to other users of Fund resources, Mr. Obame stated. In view of the potential wrong signals that a judgment such as Mr. Kaeser's could send with respect to those countries' adjustment efforts, his chair would appreciate it very much if Mr. Kaeser could reconsider the wording of the reference to the CFA franc zone countries in his final statement.

Mr. Autheman made the following statement:

I welcome this opportunity to discuss in depth the Fund's precautionary balances, after our recent discussion on the Fund's income position and on the cost of financing the Fund. I believe that there is now a need to shift from a backward-looking approach to the arrears issue, namely, building up reserves to face already existing arrears, to a forward-looking approach, namely, determining the level of balances required by our normal lending activity.

By and large, I share the staff's skepticism regarding the possibility of importing techniques used in other institutions, in view of the Fund's peculiarities. All in all, I believe that we should aim at constantly keeping a limited reserve above the existing credit outstanding to countries in protracted arrears.

The burden-sharing scheme and the strengthened arrears strategy have both proved highly efficient. Following the recent successful completion of Sierra Leone's rights accumulation program, we now have precautionary balances that more than cover our outstanding credit to countries in protracted arrears, at roughly SDR 2,800 million, as compared to SDR 1,600 million. It is also interesting to note in this respect that these balances are larger than our outstanding credit to all countries with arrears or temporary overdue obligations. We do not have any more catch-up problems, and we can therefore review the appropriateness of the rather rapid path of our increase in reserves and Special

Contingent Accounts. Incidentally, our recent discussion on Sudan shows that it would be useful to look at the exact nature of the difference between the GRA and the Special Contingent Accounts.

Within a commercial approach, we should and would probably have to provision against any new loan at a very high level, as determined more or less scientifically. First, the Fund lends to countries whose commercial lenders do not spontaneously finance. Second, whatever its existing exposure to a given country, the Fund provides credit if appropriate policies are put into place. Third, its outstanding credit is concentrated on a few countries, as illustrated by Table 3 of the paper: only 5 countries represent 50 percent of the total, 10 countries represent 70 percent, and 15 countries represent 80 percent.

But we are not a commercial lender. Ultimately, the best protection for the Fund relies on its preferred creditor status. Such a status, granted by the consensus of the international financial community, encompasses in particular two main aspects. First--and positively--creditors accept, in those frequent cases when Fund resources are provided and debt rescheduling is called for, a tailoring of the rescheduling so as to protect the repayment to the Fund. Second--negatively--to be in arrears to the Fund simply means to be "beyond the law." To be reintegrated into the international community requires considerable efforts from the country concerned, possibly backed by the donors' community through support groups.

Paradoxically, if we were to give indications that we were going to make a new hypothesis for lending, creditors or users of Fund resources might abandon this consensus, which has been elaborated throughout Fund history; alternatively, we would run the risk of weakening the consensus.

More generally, the implementation of the strengthened arrears strategy makes it irrational for any country to choose to be in arrears. Therefore, I would expect that new arrears would be linked to political or economic turmoil, the risks of which cannot be measured. Indeed, of the 11 countries in arrears as of 1989, 7 are now current, 1 is pursuing a rights accumulation program, and 2 of the 3 remaining are facing exceptional civil and political turmoil, as described in EBS/94/62. Therefore, individual country risk assessments--in any case highly judgmental--could only be speculative.

I do not say that a risk of arrears does not exist; we have suffered from a very rapid increase of arrears during the late 1980s. However, under our present rules, arrears are rather unpredictable and rare.

It is sometimes argued that the Fund's activity has recently become more risky. I do not subscribe to such an argument, for three reasons. First, the role played by the enhanced structural adjustment facility has led to a shift of activity and therefore of risk from the GRA. Second, in nearly 60 percent of the cases in which a drawing under the systemic transformation facility was granted, there has been a subsequent upper credit tranche arrangement. Finally, to consider that our activity has become more risky only because our geographical base has expanded would be a dangerous political assumption, based on the irrational hypothesis that some members might decide and could afford to cut themselves off from international capital flows.

In addition, I note that the financial consequences of our arrears are also of a peculiar nature. Three different aspects are involved here. First, there is a loss of income, but it is covered through our burden-sharing rules. Second, there is a temporary liquidity issue, as mentioned in the paper, but it is covered through appropriate liquidity rules. Finally, there is a potential loss issue, for which we need to build balances, but this is an exceptional case. The staff rightly notes that it has not occurred since the creation of the Fund and might eventually occur for the first time with Sudan.

Arrears may ultimately raise balance sheet problems, but the Fund's unique rules allow for some time before these problems become effective. Recent experience has shown that, if need be, the membership as a whole can take very bold and rapid decisions regarding the level of precautionary balances, so as to meet an emerging arrears problem. The mechanisms for dealing with such an emergency are now in place and could be activated even more rapidly than when they were created a few years ago.

I agree that caution requires that we maintain a level of overall reserves above the existing outstanding credit to countries in arrears, but I do not support the view that the greater this excess is, the better. I consider it more important that we continue to act under the unanimous understanding that, if need be, we would be prepared to rapidly increase our reserves.

For the time being, namely, during the conjunction of the downward trend in the stock of arrears and the low level of the SDR interest rate, I would advocate that our present level of reserves be kept reasonably high. I note that the staff paper characterizes as "broadly sufficient" a reserve of from SDR 200-300 million, in addition to the existing outstanding stock of arrears or, alternatively, a total reserve of 3-5 percent of outstanding credit, which is equivalent to a total level of reserve of SDR 750-1250 million. At present, our reserve level is more than 11 percent of total outstanding credit, and SDR 1100

million above the existing outstanding credit for countries in protracted arrears.

Consequently, I believe that we could lower the rate of increase of our general reserves and of the reserves in SCA-1. Such a decrease might leave some room to compensate for the creditors' shortfall with respect to the second Special Contingent Account (SCA-2).

Mr. Posthumus made the following statement:

The strengthening of the Fund's precautionary balances over the past few years is a welcome step on the road to a solid reserve level. The fact that the total of the Fund's precautionary balances has reached a level above outstanding credits to members in protracted arrears does not automatically imply that they can be considered adequate. However, the achievement of that level is a good opportunity to consider the development of guidelines to determine the desired level.

My starting point for determining the appropriate size of the precautionary balances is that all Fund members--both debtors and creditors--have an equal interest in a sound and financially solid Fund. This is the one guarantee that member countries will remain willing to increase the Fund's resources, if necessary. As long as we have no agreement on a method to determine the appropriate level of the Fund's precautionary balances, we should continue the present reserve policy, namely, an annual increase of reserves of 5 percent, an equal amount added to SCA-1, and a gradual building up of SCA-2.

I would welcome the development of guidelines to determine the adequacy of the Fund's precautionary balances. At present, the level of precautionary balances is still low, compared with that of other multilateral financial institutions, which base their policies on requirements of generally accepted bank accounting standards to safeguard their triple-A status on financial markets. Even though its financial structure is distinct, the Fund should maintain the notional triple-A status that it holds with respect to its creditors, the central banks, thus ensuring that they remain prepared to make their reserves available to the Fund. Thus, it is relevant to compare the Fund's reserve level with that of the World Bank, although they should not necessarily have to be equal.

As for the method of determining the adequate target level, the staff's suggestion to assess the risks for a few broad classes of members is too complicated, not transparent--while the Board is not involved--risks moral hazard, and is potentially--if the

results become public knowledge--to the disadvantage of the countries involved.

The staff alternatively suggests that total precautionary balances should be a percentage of total credit outstanding, on the condition that this at least cover credit outstanding to members in protracted arrears. In my opinion, some coverage of credit outstanding to all members not in arrears should be additional to full coverage of credit outstanding to countries in protracted arrears. However, a percentage of 3-5 percent of credit outstanding, as suggested by the staff, is quite low, not only relative to precautionary balances of development banks, but also to those of commercial banks. The latter are mostly required to hold large provisions for the same countries that are debtors to the Fund and, in some cases, are not even lending to these debtors. The preferred creditor status of the Fund does justify relatively lower precautionary balances, but this special position has not protected the Fund from arrears resulting from political conflict and civil war in debtor countries and from arrears resulting from the imposition of international sanctions. The range suggested by the staff would lead to considerably lower reserves than those of the World Bank, which stand at 16.4 percent.

The second alternative mentioned by the staff offers us a better framework for deciding on the level of precautionary balances. The present reserve ratio of the World Bank would be reached if, on top of full coverage of credit to countries in protracted arrears, a percentage on the order of 10 percent of remaining credit outstanding were used. The staff's suggestion that total precautionary balances should at least cover a certain part--say, one half--of credit outstanding to the largest user of Fund's credit deserves support.

Concerning the Fund's gold holdings, I support the staff's cautious position. Gold offers some added security, but it should be emphasized that a forced gold sale would unavoidably diminish the value of the Fund's gold and should therefore be avoided. An appropriate level of precautionary balances therefore remains important.

On the issue of write-offs, an amount of precautionary balances that exceeds the amount of credit extended to members in arrears is the best guarantee that a decision whether to write off would not be constrained by financial considerations.

Finally, if the Board decides to maintain a sufficient growth of precautionary balances, I could accept a decision to reduce the adjustment of the rate of charge under extended burden sharing. A slower buildup of SCA-2 is acceptable in light of the slower than

expected takeoff of rights accumulation programs and would, at the same time, respect the intended contribution ratio between debtor and creditor members. I agree with the staff that it is "not reasonable now to reduce the intended size of the SCA-2" while it is still uncertain to what extent the encashment of rights for eligible countries will be financed from the GRA or ESAF resources.

Mr. Dorrington made the following statement:

At the June 1993 Board meeting, I and a number of other Directors argued that we did not have sufficient information to make a well-informed judgment on the appropriate level of the Fund's precautionary balances. We thus called for a paper that would examine the practices of others, including the World Bank, and assess the implications for the Fund. This paper goes a long way in that direction, and I thank the staff for it.

I will make six general comments and then respond to the specific issues of paragraph 80 of the staff paper. First, the Fund is a unique institution, and thus it would simply not be appropriate to copy the practice of some other institution and apply it to the Fund, although I would be interested in the staff's reaction to the impression I get that the World Bank has rather larger reserves, proportionately, than the Fund.

Second, I agree with Mr. Posthumus that it is essential that we be sufficiently prudent, so that members unambiguously remain prepared to make their reserves available to the Fund.

Third, the prime guarantee of the Fund's assets is the quality of the programs implemented by the borrowing members. Whatever we agree regarding precautionary balances, it is essential that this not lead to any laxity in conditionality. The Fund's preferred creditor status is also a powerful second line of defense.

In passing, I must react to the suggestion in Mr. Prader's statement that "the real origin of these discussions on Fund reserving seems to be the second thoughts of some members about the value of the Fund's conditionality" and that the "proper context" is "the perception of increased risk owing to lending to countries of the former Soviet Union." At least as far as this chair is concerned, that assertion is simply not true. The proof that our concerns are not motivated by second thoughts regarding the FSU is that in this Board on June 5, 1992--when none of the FSU countries had borrowed from the Fund and half were not even members--Mr. Peretz expressed views similar to my own when he complained of "the lack of any real benchmark against which to judge the adequacy of reserves."

My fourth general comment is that while indicators such as those described in the staff paper can be valuable aids to judgment, they can never be a substitute for judgment.

Fifth, it is essential that nothing approximating a Fund rating of individual countries get into the public domain. If the staff "rates" countries, those ratings should be available only to others on a strict need-to-know basis for the purpose of compiling aggregate risk measures. I understand that such a procedure works satisfactorily in the World Bank. Furthermore, except for countries in protracted arrears, precautionary balances themselves should not be associated with particular members.

Almost all of the remainder of my remarks will relate to methodology, rather than the precise level of precautionary balances that is appropriate. It is logically possible for Directors, while having differing views on whether the current level of precautionary balances is about right, to agree on the methodology to be applied; similarly, it is perfectly possible for people who disagree on the appropriate level for the speed limit on the roads to agree on the design of speedometers. However, I do not see anything in the paper before us today that leads me to believe that the current level of precautionary balances is grossly inadequate.

Turning to the specific issues summarized in the last paragraph of the staff paper, I will deal first with the case of countries currently in protracted arrears. Here, I believe that current practice is appropriate, namely, we should seek to maintain precautionary balances equal to 100 per cent of credit outstanding to members in protracted arrears.

More controversial is whether we should maintain any precautionary balances in respect of countries that are not in protracted arrears. The arguments on both sides were rehearsed at the meeting in June 1993, and I fully accept that there are deeply felt and wholly respectable arguments on both sides. I will not repeat these arguments beyond saying that it is clear that there is a nonzero risk associated with credit outstanding to such countries. I believe that it is consistent with the monetary nature of the Fund to take a prudent approach and to maintain some general precautionary balances, as the Fund has done continuously since 1958.

It seems clear to me that general precautionary balances should be primarily determined as some percentage of aggregate exposure to members, excluding those in protracted arrears, because to include them would lead to double counting. I agree that, barring major developments in the interim, it would be appropriate to reconsider the appropriate level of precautionary

balances annually, at the same time that we consider the net income target and the rate of charge. Like the other information used as input in determining the net income target and the rate of charge, calculations relating to the appropriate level of precautionary balances should take into account projected changes in credit outstanding during the year ahead.

If this is accepted, then we will have to decide what percentage to use initially. I note in passing from Table 2 in the staff paper that total precautionary balances less credit outstanding to members in protracted arrears is currently equal to about 4 1/2 percent of credit outstanding to nonarrears members.

The judgment on the initial percentage will not be an easy one, but it should be an informed one. It would be useful to have four complementary types of information. First, an objective measure of risk should be prepared. A risk index along the lines of that developed in Attachment VIII of the staff paper is probably about as good as such an index can be. What it does not--and cannot--include is any explicit measure of political risk. It is clear that a number of cases of protracted arrears are, at least in part, due to political rather than strictly economic factors. However, the index has two advantages over some other indexes in that it takes account of a broad range of factors and, hence, is unlikely to be dominated by spurious changes in one factor; and, most important, it is explicitly Fund relevant both in terms of some of the factors employed and the design of the weighting system.

Thus, I believe that such an index is useful. Each time that we consider the appropriate level of precautionary balances, I would wish to see a table such as that on page 64 of the staff paper, but also taking account of projections of credit outstanding and with the index expressed as a percentage of outstanding credit to countries not in protracted arrears.

The second type of information that I believe would be useful is a measure of risk based on subjective, but nevertheless well-informed and comprehensive, staff assessments of risk. One such scheme is outlined in the staff paper. I have two comments on the specifics of the example given. First, I would have thought it preferable to use more than 3 categories of risk, for the same reasons given for the use of 11 categories in the U.S. interagency system for assessing country risks--although I do not believe it necessary to go that far. My second comment derives from the fact that the illustrative calculations can be decomposed into three stages. In the first stage, countries are allocated to groups. In the second stage, the relative riskiness of the groups is quantified, and a weighted measure of aggregate assets at risk can be calculated by giving a weight of unity to the riskiest group.

In the example given, this measure would be equal to total exposure to the third group, plus half of the exposure to the second group. Finally, an assumption can be made for the absolute risk of the riskiest group-- 10 percent is used in the example-- and the result of the second-stage calculation is simply multiplied by that percentage.

I do not see any advantage in the staff's undertaking this final step, which essentially prejudges the result of the Board's consideration, for it is designed as an input. Thus, I would prefer the results to be presented in the form of the output of the second stage of the calculation. This total, when expressed as a percentage of amount of credit outstanding to nonarrears countries, could be used as a second input by the Board in judging the appropriate percentage for general precautionary balances.

The third type of information is some measure of concentration of exposure, both to individual countries and to groups of countries subject to correlated risks, such as close trading partners or major exporters of particular commodities.

The staff should provide anything else that it considers relevant. By contrast, I do not believe that there is any benefit in attempting to assess risk by reference to particular Fund facilities.

I see the greatest benefit in such an approach occurring when we review each year the percentage rate of general precautionary balances. We would then have in front of us changes in the objective and subjective indexes, concentration of exposure, and other material, all of which would help in forming a judgment on changes in risk compared with a year earlier. Indeed, I believe that the indicators are potentially far more powerful in helping to recognize changes in risk than in determining the absolute level of risk. We could then make an informed judgement as to whether there was any need to change the percentage rate of desired general precautionary balances.

In conclusion, I do not believe that the approach that I have outlined is beyond criticism--far from it; however, I am convinced that it would be a considerable improvement on our current practices.

Mr. Prader said that, as the debate on lending to Russia had been in full swing since March 1992, it was by no means obvious that the remarks made by Mr. Peretz in June 1992 about the adequacy of precautionary balances had not been triggered by concerns about the Fund's conditionality policy.

Mr. Dorrington remarked that it would not be fruitful to get into a protracted discussion at present on that topic. Directors would simply have

to either accept or reject his assurance that his chair's interest in the adequacy of the Fund's precautionary balances predated--and was not motivated by--concern about that institution's conditionality policy.

Mr. Törnqvist made the following statement:

As some of you may recall, this chair has been fairly critical of earlier papers on this subject. Let me say that the report that we have before us today provides clear analysis and extensive background material, and it is a good basis for our discussion of the difficult and complex issues related to the Fund's precautionary balances. I wish to commend the staff for the effort that it has made this time.

I can support almost everything that Mr. Dorrington just said, and also much of Mr. Posthumus's comments.

The basic thought that has guided this chair in previous discussions has been that the level of the Fund's precautionary balances is an important matter. For this reason, it needs to be determined as carefully as possible, in a systematic and consistent way. We are certainly aware that no perfect, or even very good, method for assessing credit risks exists today. Much judgment has to be applied. However, like Mr. Dorrington, we cannot see this as a good excuse for not using any method at all. The Fund should exercise its best judgment, based on a systematic use of all available relevant information. Despite the difficulties, which admittedly are great, it is more dangerous to be inconsistent or overly simplistic than to be quasi-scientific, as Mr. Prader calls it. However, it is important to be aware of the limitations of the methods that one is using.

An important argument in the discussion has been the uniqueness of the Fund as a financial institution. It is certainly true that conditionality is a unique safeguard, as is the Fund's preferred creditor status, and that these should be taken into account when assessing the need for precautionary balances. However, there are other unique features that argue for very prudent financial management. Thus, it must be remembered that the claims on the Fund by its members are normally regarded as part of their foreign exchange reserves, unlike the claims on other international financial organizations. Another such feature is the monetary character of the Fund.

After this general remark, I wish to comment on the main conclusions drawn by the staff. I agree that the precautionary balances should at least cover credit outstanding to members in protracted arrears. However, my authorities believe that the Fund must have a more forward-looking risk strategy. In order to fully take into account the potential risks, the Fund's precautionary

balances should also be related to the Fund's total financial activities. To arrive at such a relation, one should utilize all information that could help in assessing the Fund's exposure to credit risk. Here, some kind of individual country risk analysis is probably unavoidable.

However, the risk that such assessments become public knowledge should be taken seriously, and it should be reduced as much as possible. To this end, one could consider aggregating countries with debt to the Fund above a certain minimum level into broader groups. Doing so has some disadvantages, as Mr. Posthumus has pointed out, but it would still contribute to making the link between precautionary balances and the Fund's risk exposure closer, and it might represent a reasonable compromise. It might also be appropriate to assign different risks based on, inter alia, different types of facilities or regional distribution of loans. This matter will have to be considered further.

The adequacy of the Fund's precautionary balances should be reviewed regularly, and any changes in the level of these balances should be determined by the Executive Board in the context of the annual review of the Fund's income position. The staff's review and recommendations should rely not only on the evaluation of exposure to risk and adequacy of precautionary balances; as the theme of precautionary balances is strongly intertwined with the question of burden sharing, the two should be evaluated jointly. A short assessment of the cost effects of accumulation of precautionary balances could complement the annual review.

In conclusion, much work remains to be done before we can find a satisfactory method for determining the adequate level of the Fund's precautionary balances. However, with this paper and today's discussion we have made a good start, and I believe that it would be fruitful to continue along the lines that I have indicated.

Mr. Newman made the following statement:

This paper starts in the right direction in exploring methods for arriving at a more systemic, forward-looking means for accumulating precautionary balances. Unfortunately, at some point during this journey, the staff seems to have lost the trailblazing spirit that we had hoped to see. The paper is rather tentative in suggesting the need for action to take account of the riskiness of the Fund's nonarrears credit outstanding and surprisingly relaxed, we believe, in its conclusions on possible appropriate levels of precautionary balances. This is particularly so at a time when the Managing Director is reminding us of the risks of Fund lending and proposing specific measures to reduce those risks.

The staff is to be given credit for focusing on an important topic. The Fund's current backward-looking means for judging the adequacy of precautionary balances flies in the face of accounting principles, is an inherent source of uncertainty, and is bound to result in volatility in the rate of charge and remuneration, as such rates must react to problems instead of anticipating them. Such a process calls into question the control exercised over the financial management of the institution. There is also a fairness issue as current borrowers and creditors must shoulder the costs of previous loans. In essence, current borrowers and creditors are providing a retroactive subsidy to old borrowers. Such an arrangement neither inspires confidence nor engenders support.

The paper's discussion of approaches by other official and multilateral creditors is informative. What is clear is that other multilateral creditors, as well as some large official creditors, do seek to match the level of precautionary balances with the perceived riskiness of their portfolios. This includes recognizing the true cost of borrowing as loans are made--not years later, when problems arise. In the case of the World Bank, this process involves detailed risk assessments of individual countries, which are factored into an overall assessment of the desirable level of provisioning. It is worth noting that the equivalent level of precautionary balances in all the MDBs is higher than the Fund's, a point to which I will return.

We find the approaches taken by other multilateral creditors to be instructive--more so than the staff, who, while appearing to agree with the general principle of provisioning now for future shortfalls, seems to believe that the Fund's various strengths and unique characteristics mitigate against establishment of a similarly disciplined approach here. We have problems with aspects of this line of reasoning in the paper.

There seems to be the suggestion that because the MDBs depend on international capital markets for funding, they must be more strict in accounting for the possibility of losses. This may be true in practice, but it creates the rather discouraging impression that creditor flows from Fund quota resources require less reserve protection by virtue of the fact that they come from what is perceived as a less discriminating source. This is not a message that will win points with creditor country taxpayers.

We recognize the distinction in capital structures between the Fund and the multilateral development banks. The reliance of MDBs on capital markets compels a more conservative approach to establishing levels of precautionary balances. The unique willingness of Fund creditors to engage in burden sharing substantially lowers the cost of arrearages to borrowers. At the same time, the backward-looking approach to dealing with arrears

carries some substantial costs to borrowers as well as creditors, which raised enough concern in recent years to generate support for the strengthened arrears strategy.

This strategy, as the paper notes, has contributed importantly to reducing outstanding overdue obligations. At the same time, its effectiveness also depends on a tighter timetable of remedial measures, which include compulsory withdrawal and the more rapid prospect of a write-off of overdue repurchases.

Regarding the level of precautionary balances necessary to cover actual and potential overdue repurchases, we believe that the amount of coverage ought to encompass the credit outstanding from protracted arrears cases, plus some share of those current in their obligations to account for possible future arrears. As the paper explains rather exhaustively, attempting to quantify the risk of loss on credit extended to members current in their payments is difficult and, in the end, must be supplemented by substantial judgment. Clearly, the Fund enjoys various advantages by virtue of the conditionality attached to its programs, its surveillance activities, and its preferred creditor status. Nevertheless, and notwithstanding progress made under the strengthened arrears strategy to prevent and deter new overdue obligations, experience clearly indicates that new arrears are a regrettable eventuality that must be anticipated.

There are a number of ways to arrive at a level of precautionary balances that covers risks from borrowers in arrears and those who are current. The paper discusses both the techniques for assessing risk and the ways in which those assessments might be applied to precautionary balance levels. Regarding the former, we do not have any theological views on how risk assessments ought to be conducted in getting to an adequate level of coverage. The overall approach would seem likely to include, at least informally, judgments on programs in individual countries, and one might expect the distinction among the three approaches described in the paper to be blurred somewhat in practice. Confidentiality would need to be maintained, of course, but the possibility of leaks should not necessarily decide against a superior basis for assessing risk.

We are more concerned with the adequacy of the balances, and we are not reassured by the figures in the paper. It is suggested, for example, that the precautionary balances might be set at 3-5 percent of the share of total credit outstanding, a figure mentioned during the June 1993 discussion. As indicated in Table 2, at 3-5 percent, precautionary balances would not even cover overdue repurchases--not to mention credit outstanding to arrears countries--and would leave no cushion for future arrears

accumulation. The last time that precautionary balances were in this range was in the mid-1980s, when the arrears problem began to take off and reserve balances were deemed to be insufficient. Other figures mentioned in the paper also underestimate the chances of future arrears arising.

Underlying these low benchmark levels may be the thought that actual write-offs will occur only once in a blue moon and with plenty of warning--thus giving plenty of time to build up balances as arrears accumulate. Such reasoning would seem to miss the point of this exercise. Regardless of when write-offs actually do take place, preparing for their possibility ought not be delayed and foisted on the backs of future creditors and borrowers. Instead, they should take place on a more gradual, accrual basis. Also, establishment of the strengthened arrears strategy indicates that the accumulation of arrears into perpetuity by a country is not acceptable.

More clearly influencing the illustrative benchmarks offered is a rather sanguine view regarding the likelihood of future arrears cases. The Fund's sister institutions are clearly less confident. All have precautionary balances that exceed current levels at the Fund. Also, Fund balances, which are currently just over 10 percent of outstanding credit, are still twice as high as those suggested in the paper. The market seems to be applying a measure of discipline in other institutions that we would be foolish to ignore.

Under current global conditions, the Fund will need to take risks in supporting adjustment efforts. Underlying the precautionary balance benchmarks offered in the paper seems to be the view that the Fund will not or should not loan to countries that it believes might fall off the wagon. This is sound enough in theory, but the real world never offers neat distinctions across the spectrum of country risk. Experience suggests that new arrears are likely to emerge despite our best efforts to prevent them, and current lending activity in a number of transition and fragile economies suggests little diminution in risk levels. Strong adjustment programs offer credible assurances, but any number of exogenous shocks can quickly alter for the worse conditions in many borrower countries.

To sum up, we favor a more prospective assessment of risk associated with outstanding Fund credit, but we are concerned that the staff may be inclined toward too low a level of precautionary balances. Thus, we would advocate an approach that provides coverage of existing credit outstanding to arrears countries, plus an appropriate cushion that reflects risk assessments of the remaining balance of credit outstanding.

Mr. Fukui made the following statement:

First of all, I commend the staff for having prepared such a comprehensive analytical paper. The paper provides us with wide-ranging assessments of the methods of risk evaluation by private commercial banks and other international financial institutions, and of issues related to the adequacy of reserves.

Before coming to the main conclusions of the staff's analysis, I would like to make some remarks on alternatives suggested by the staff. The method of linking precautionary balances to total credit outstanding might be theoretically appropriate; however, if adopted, it would be impossible to avoid the problem of having to establish some criteria--numerical criteria, it is to be hoped--to link precautionary balances to credit outstanding. It seems the staff has in mind the idea of holding 3-5 percent of total credit outstanding as reserves, as was discussed previously. However, as long as these figures are not justified by some criteria, this approach does not have any meaning. Even this additional staff paper does not provide any evidence to justify the choice of 3-5 percent.

Therefore, from the viewpoint of establishing some rational criteria required to adopt this approach, it would be necessary to consider a method of making an analytical assessment, such as the method suggested by the staff to categorize indebted member countries based on the degree of risk in their arrears. The assessment would be done in aggregate form; it would be explained to the Board but not made public. Our tentative calculation on this basis, namely, full coverage for countries in arrears, 5 percent coverage for the second group of countries, and 10 percent coverage for the third group of countries, shows the total reserve requirement would be about SDR 1.2 billion, which is about 8.8 percent of credit outstanding.

Some might argue that it is problematic that a country's risk be evaluated by the staff after the Board has approved the credit, and that the detailed contents of this assessment not be disclosed to the Board nor made public. However, because information obtained from member countries on the occasion of discussions on use of Fund resources and Article IV consultations is not necessarily up to date, and because such discussions are not always held in a timely manner, it would be reasonable for the staff to make periodic reassessments of risk. In any event, it is important to establish a broad framework of assessment, so long as the method of linking precautionary balances to total credit outstanding is to be adopted. I am not necessarily advocating this grouping approach, but I would like to emphasize that without some analytical criteria, it is difficult to agree to link precautionary balances to overall credit outstanding.

Instinctively, however, I think that the range of 3-5 percent is on the low side.

The alternative of risk indexing is of some interest. However, as the calculations used to draw the index are affected by the variables included in the calculations and also by their weight, there are a number of issues to be examined under this approach. Although this approach deserves further study, it would seem to be difficult to adopt from a practical point of view.

In light of these considerations, I would like to give my views on each of the main conclusions of the staff's analysis. I support Conclusion A, assuming that precautionary balances would cover fully credit outstanding to members in protracted arrears. Regarding the second sentence of the relevant paragraph on page 31, I would appreciate the staff's comments on whether, depending on the result of the assessment, there might be any cases in which precautionary balances would not fully cover a country in protracted arrears.

Conclusion B should, like Conclusion A, be supported. If it is assumed under Conclusion A that precautionary balances should fully cover credit outstanding to member countries in protracted arrears, Conclusion B becomes redundant.

I support Conclusions C and D. As I said earlier, it is not clear how the possible risk of arrears in the future is to be quantified, nor what sort of criteria will be applied by the Board to determine this risk.

With regard to Conclusion E, the review should be made, reflecting Conclusion E(ii) in principle; however, the larger users of Fund credit need to be carefully watched.

I also support Conclusion F. As with Conclusion C, however, it is not clear what sort of criteria will be applied by the Board to determine risk. Even if I supported this approach, I would not expect risk assessment to be more analytical than it is at present.

Finally, although this consideration on precautionary balances is a continuation of previous discussions, we cannot draw the conclusion from today's discussion that a strong analytical base will be introduced into the method of risk assessment.

In light of the special nature of the Fund, and also because of the highly judgmental nature of this issue, it should be decided by taking all the elements into account when reviewing the financial position of the Fund. Nevertheless, it should be mentioned that the present method of maintaining an annual accrual

of 5 percent of reserves--which would mean a doubling of reserves in about ten years--seems to be functioning effectively; also, the present level of precautionary balances is enough to cover the risk for the time being, based on any criteria for measuring the level of reserves. Moreover, according to the tentative calculations mentioned earlier, the present level of reserves is neither excessively high nor overly precarious.

In view of the increasing possibility that a number of new members will make active use of the Fund's resources under its facilities, it is necessary to make a prudent judgment as to whether the present level of reserves is sufficient, taking into account the Fund's future activities. In conclusion, I see no compelling reasons to change the present practice.

Mr. Verjbitski made the following statement:

The staff has prepared an interesting follow-up paper on the issue of the Fund's precautionary balances and must be commended for the meticulous analysis of the risk-assessment practices of other financial institutions that lend to sovereign borrowers. On the basis of the paper, two main conclusions can be drawn.

First, the Fund's uniqueness clearly prevents us from relying on the existing methods of sovereign risk assessment in other international financial institutions and government agencies. The Fund lends primarily to countries that experience balance of payments problems. Countries' capacities to repay are generally expected to improve over the medium term, as a result of the implementation of Fund-approved adjustment programs. I agree with Mr. Dorrington that the quality of programs--that is, adequate design and conditionality of Fund-supported programs, including built-in contingency mechanisms and back-loading techniques--is therefore the major factor guaranteeing a timely repayment of loans while limiting the Fund's risks. The other key factors that help minimize the Fund's risks, where program implementation is weak, are the Fund's preferred creditor status and the very successful strengthened cooperative strategy to deal with the problem of protracted arrears. In view of these factors, I agree with Mr. Kaeser that the case is not strong enough for the Fund to establish a credit-rating system for its members. This system will hardly bring any benefits to the Fund's decision-making process; it will certainly add to the heavy workload of the staff and create the same problems of data sensitivity that currently preclude the World Bank staff from showing the results of its in-house country risk assessment, even to its Directors.

Second, the amount of credit outstanding to members in protracted arrears is the best, if not the only, available quantifiable risk indicator for determining the necessary level of

the Fund's precautionary balances. As to the unquantifiable risks related to the future repayment capacity of members that are current in meeting their financial obligations to the Fund as they fall due, these can be safely disregarded until actual arrears occur and the risks become quantifiable, thereby warranting additional provisioning by the Fund. The "hidden but apparent" reserves of some SDR 20 billion in the form of undervalued gold assets provide the Fund with a very comfortable cushion against all unidentifiable risks. In this regard, Mr. Prader is absolutely right in his observation that any serious discussion of the adequacy of the Fund's precautionary balances should include the gold factor. The respective unrealized gains, as the staff admits in the paper, are "virtually certain."

As our position on the issue of precautionary balances has not changed since the discussion in June 1993, and as I find myself on the same wavelength as Mr. Prader on virtually all major aspects of this issue, I shall limit myself to only one comment where our positions do not overlap.

Although I support the view that the Board should not be biased in the direction of raising reserves, lowering their level, even when the opportunity arises, will be difficult for one reason--the reserves have recently become a very important source of income for the Fund.

Mr. Schoenberg made the following statement:

I would like to join previous speakers in commending the staff on a well-written, well-focused, and, at the same time, very comprehensive paper. The staff has done much empirical research in preparation for this discussion, which deserves our appreciation. As to my own contribution, I apologize for a rather technical statement, but, after all, we are here dealing with a rather technical subject.

In commenting on the issues addressed in the paper, like Mr. Dorrington, I wish to stress at the outset that one basic conclusion of our most recent discussion on this subject in June 1993 was that the main protection for the Fund against possible loan losses lies in the quality of its loan arrangements. Therefore, the maintenance of adequate conditionality and surveillance in the framework of Fund-supported programs is of overriding importance. Fund programs must be designed and monitored in a way that ensures the attainment of a viable balance of payments position over the medium term. It is obvious, however, that even the best policies cannot altogether eliminate the inherent risks in the Fund's lending activities. If the Fund were to attempt to design its credit programs with the objective of excluding any risks, such a policy would be widely considered

as too restrictive and demanding on its members. The Fund thus needs a certain level of precautionary balances in order to protect its financial integrity.

As for the desirable size of these balances, I believe that the Fund should aim at levels that cover not only all credit outstanding to members in protracted arrears, but also the potential risks stemming from credit to members not in arrears, on the grounds that some of these members may incur payments problems at a later stage. I agree with Mr. Dorrington and Mr. Newman that we need a forward-looking approach.

As to the assessment of this latter risk component, I have the impression that such potential risk can be only roughly estimated, and not exactly quantified. Therefore, I see no need to evaluate the potential credit risk in respect of each individual Fund debtor. Such a procedure would be very complicated, could prove costly, and may not in the end lead to more meaningful results than rough estimates. In addition, it cannot be precluded that country-specific risk evaluations by the Fund would be made public, which could impair the credit standing of Fund debtors in the international financial markets.

To some extent, these arguments may also hold true for the approach of evaluating the Fund's exposure in terms of different classes of Fund debtors, as discussed, inter alia, by the staff. Highly sophisticated calculations might here create a false impression of rationality. Saying that, however, should not be taken to mean that we would refuse to look further into such an approach.

I also have certain reservations vis-à-vis the proposed approach of linking the level of reserves to a quantified risk index. This method, as described in detail in the staff paper, would entail various difficulties and, on the whole, might neither be very practical nor necessarily achieve better results. I thus tend to support, in principle, the approach of linking the desired level of such reserves to the total volume of credits outstanding. According to our calculations, the ratio of reserves not required to cover credit outstanding to members in protracted arrears to the volume of credit outstanding to members not in arrears stands presently at about 4 percent.

One possible method of assessing the adequacy of this level could be to compare the Fund's reserve ratio with the corresponding ratios of other international financial institutions. As the Fund's credit risk might be regarded as somewhat lower than the risk of the other institutions--for instance, owing to the Fund's preferred creditor status--the

relative size of the Fund's precautionary balances might also remain somewhat below that of other multilateral institutions.

It might be useful to do some further research on the corresponding ratios of other multilateral institutions. Based on such comparisons, the staff might come to the conclusion that the Fund's current ratio of about 4 percent is broadly adequate, at least for the moment. Nevertheless, I have some sympathy for Mr. Posthumus's view that such a ratio is relatively low, compared with, for instance, the corresponding ratio of the World Bank. It may thus be prudent, even taking the peculiarities of the Fund into consideration, to aim at a somewhat higher ratio over the medium term. Such a strategy may also be prudent because the Fund might face larger risks in the years ahead, owing to its anticipated credit expansion and the difficult political and economic situations in a number of debtor countries. Mentioning in this context certain groups of countries does not necessarily constitute a singling out, in my view; it is rather an acknowledgment of the objectively difficult situation in many countries. The exact level of the ratio would, of course, have to be adjusted in line with changing circumstances in further Board discussions.

Let me turn to a question not explicitly addressed in the staff paper, namely, in which form and in which accounts precautionary balances should be maintained. In our view, the Fund should keep its precautionary balances as far as possible in the form of its so-called total reserves, that is, in the form of open general and special reserves, rather than in the Special Contingent Accounts, as only the former are permanently at the Fund's disposal. The Special Contingent Accounts have a temporary character and serve a special purpose.

I also believe that the Fund should aim at a steady increase in its precautionary balances, if this would be considered as necessary, until the targeted reserve level is met. To this end, we might maintain our proven procedure to set annual net income targets in the form of a constant percentage of total reserves, currently 5 percent, until the adequate level of precautionary balances is achieved.

Concerning gold, I fully support the staff's deliberations regarding the importance of the hidden reserves in the Fund's gold holdings. Therefore, I see no need to make additional comments on this very sensitive issue.

Mr. Ismael made the following statement:

I agree with Mr. Prader that the level of the Fund's reserves is adequate, and that the rate of accumulation of the

precautionary balances is currently extremely high, which would allow some room to have the current rate reduced. I also agree that the various elements of prudent Fund policy, namely, reserve accumulation, undervaluation of assets, the strengthened arrears strategy, and prudent policy recommendations, are more than adequate to protect the Fund against any residual risk.

If we follow a one-to-one coverage principle, it is not necessary to hold precautionary balances for more than the amount of protracted arrears. However, I sense that there is a growing concern about the increased risk, owing to recent large loans to a number of member countries with relatively similar economic difficulties. Here, the crucial problem is how to identify and quantify the risks involved. Each of the three alternative approaches proposed by the staff, however, is not free from major problems and consequently may not be satisfactory.

In addition, there is still no consensus on how the appropriate level of precautionary balances should be determined. In the absence of such a commonly agreed method, this chair accepts the staff's conclusion that the target amount of precautionary balances should be reviewed in the light of the staff's assessment of risk associated with outstanding Fund credit and a judgment as to whether the level of precautionary balances appeared broadly adequate to cover the present and foreseeable exposure of the Fund to risk. In essence, this is a continuation of the present conservative reserve policy.

Mr. Jiménez de Lucio made the following statement:

We welcome this new opportunity to discuss the issue of the Fund's precautionary balances. The initial point to consider in the discussion is the Fund's unique nature, which distinguishes it from any other financial institution. The Fund lends only to members that agree to observe macroeconomic conditions consistent with medium-term balance of payments viability: it provides financial resources only to members that agree to meet criteria designed to make possible the repayment of external obligations.

In addition, the Fund enjoys in practice a double preferred creditor status: first, as formally agreed to by members; and, second, in view of the fact that in most cases today the prerequisite for any borrowing country to be a member in good standing of the international financial community is to be current in its obligations to the Fund.

If we take into consideration the Fund's unique nature and its double preferred creditor status, the risks associated with its financial support to member countries are substantially lower than for any other financial institution. This does not mean, of

course--as the existence of members in protracted arrears demonstrates--that there are no risks associated with its credit facilities, only that these risks are unusually low.

We consider the present policy of having sufficient precautionary balances to cover the total credit outstanding to members in protracted arrears as conservative and adequate to protect the Fund from the risks associated with credit outstanding to both members in arrears and those current in their payments. The likelihood that all members in protracted arrears will not honor their obligations is low. Experience to date fails to show even one case of a member or former member not settling its debts eventually. On the contrary, the present arrears strategy has proved successful in reducing the number of members in protracted arrears. The likely scenario is that, over time, some of these countries will normalize their relationship with the Fund while new countries may fall into protracted arrears. Therefore, the present policy regarding precautionary balances seems adequate to cover the Fund against the risks associated with its total credit outstanding to all members.

We welcome the staff's reference to the role of gold holdings in relation to the institution's precautionary balances, and we agree with its assertion that the Fund's gold holdings effectively bolster its precautionary balances. The fact that the market value of the gold holdings today, SDR 25.8 billion, exceeds the institution's total outstanding credit, provides more than "some" security for the Fund's subscribed assets.

In closing, we see no reason to introduce any change in the Fund's current policy on precautionary balances or to increase their present level, although we agree that the subject should be reviewed periodically by the Board. This position is based, of course, on maintaining the present policies regarding conditionality and the Fund's catalytic role. Abandoning these traditional principles would result in the loss of the Fund's unique nature in many ways. Among other consequences, it would entail a need for an immediate review of the policy on precautionary balances and their expensing.

Mr. Obame made the following statement:

Like previous speakers, I welcome this opportunity to review the Fund's policy on precautionary balances. The staff should be commended for providing the Board with a comprehensive paper on this issue. I find the report helpful in providing a description of the experiences and practices of other private and official lenders concerning risk assessment and provisioning. With regard to the Fund's evaluation of precautionary balances, while I share some of the staff's views on the need to better protect Fund

resources, I do not find sufficient grounds for changing our current conservative policy. As can be seen in Table 2 of the staff paper, not only does the current level of precautionary balances provide adequate protection against possible losses that could occur in the Fund's lending operations to its members, but it has also enabled the Fund to achieve a fixed target to cover all outstanding credit to countries in protracted arrears. Moreover, the Fund's gold holdings--which constitute a good cushion--the Fund's strengthened strategy on arrears, the access policy, and the continued application of conditionality and its preferred creditor status, all provide the Fund with a unique opportunity to minimize any residual risk.

Turning to specific issues for discussion, we wish only to react to a few points. We generally can agree that when arrears become protracted and--as is now done--precautionary balances are used to cover members' overdue obligations, the burden-sharing arrangement is appropriate. However, we have difficulties with the proposed automatic extension of coverage of such precautionary balances to cover outstanding credit. Such an approach is tantamount to making a judgment on country risk that does not take into account the exceptional temporary factors that caused the arrears situation. We share Mr. Prader's concern that this might give rise to a moral hazard issue. Moreover, as indicated in the staff paper, Fund support and its catalytic role will remain critical for these countries. We do not share the view that the level of precautionary balances should include some provisions based on an anticipation of possible arrears. Such an approach is too judgmental; like most speakers, we strongly caution against the use of highly judgmental and questionable risk-assessment techniques that can have repercussions well beyond the issue of protection of Fund resources.

Our view is similar to that expressed by other speakers, including Mr. Prader, on the continuation of the present pragmatic approach.

Mr. Smee made the following statement:

Like my colleagues, I wish to thank the staff for a paper that was exactly what we had asked for in terms of providing us with more information. Even if in some cases the information did not lead us to the results that we might have anticipated, it is still very helpful to our discussion today.

When we discussed the adequacy of the Fund's precautionary balances in June 1993, I suggested that it was necessary to adopt a forward-looking approach that addressed two fundamental questions. First, what ratio of precautionary balances to outstanding credit is prudent in the light of both existing

arrears--the backward-looking aspect--and perceived risk over the medium term--the forward-looking aspect? In this regard, of course, the quality of programs is key. Second, how quickly should the Fund reach that level of precautionary balances?

In essence, we are attempting to answer these two questions today. First, we have to determine our starting point, and we believe that only total reserves plus SCA-1 should be included in our assessment of precautionary balances, as quantified in Table 2, Attachment VII of the paper. SCA-2 is a different type of special account, designated for rights accumulation program countries that are in the process of moving from a position of protracted arrears to one of creditworthiness in the eyes of the Fund. As such, SCA-2 should not enter into our discussion on general precautionary balances.

As of January 31, 1994, total reserves plus SCA-1 amounted to SDR 2.231 billion, while credit outstanding to members in protracted arrears stood at SDR 1.782 billion. Thus, we have satisfied what should be our first objective--that the Fund have a level of precautionary balances that fully covers the credit outstanding to members in protracted arrears. Furthermore, we can all agree that the Fund's precautionary balances should be increased over time if additional arrears arise and become protracted; conversely, the balances should be decreased if the arrears fall as a result of our cooperative arrears strategy.

That leaves the task of determining the desired level of balances that are truly precautionary, including some provision for the possibility that arrears may arise that are related to credit to members that are current in meeting payments to the Fund as they mature. These extra precautionary balances form our second line of defense against protracted arrears in the future. On January 31, 1994--again, I am only counting reserves plus SCA-1--these balances amounted to SDR 449 million, or 1.9 percent of the SDR 23.336 billion of total credit outstanding to members that are currently meeting payments to the Fund as they mature.

Table 3, Attachment VII indicates that 53 percent of Fund credit--just under the GRA, not the SAF or ESAF--is taken up by five countries. The share of total credit outstanding to members that are current in meeting payments as they mature for those five countries rises to over 57 percent. This subclass has an average credit outstanding of about SDR 2.673 billion. The amount outstanding to all members in good standing is SDR 389 million, on average.

When we try to establish criteria, we must in the first instance establish criteria that enable us to cover comfortably our current outstanding credit. I do not think that

we should do a risk rating of individual countries by allowing the staff to aggregate credit outstanding on an annual basis and telling us whether we should raise or lower the amount that we are setting aside. What I would propose is that we satisfy two criteria: first, to cover one fourth of the average credit outstanding of the five largest borrowers; and, second, to cover approximately double the average of all borrowers, including the five largest.

By following those two criteria, two of our five largest borrowers could fall into protracted arrears, and we would still have that amount covered in these precautionary reserves over and above what is covered currently in protracted arrears. Moreover, the average loan outstanding to all members in good standing is SDR 389 million, and about SDR 700 million would be needed to cover double that amount, according to our criteria. SDR 700 million would correspond to about 3 percent of total Fund credit outstanding, less protracted arrears, which we believe is adequate. As we have already accumulated extra precautionary balances of about SDR 450 million, that would mean adding another SDR 250 million to the precautionary balances on the basis of the credit outstanding as of January 31, 1994.

Obviously, any increase in the net credit outstanding would also be reserved against, according to the 3 percent rule implied in my proposal. Any additional protracted arrears arising in the future would need to be fully provisioned against. This ratio would then be revisited every year to determine, on the basis of discussions with the staff, whether that current level was still correct.

With respect to the two questions that I raised at the June 1993 discussion, I have answered the first one: the precautionary balances should cover 100 percent of protracted arrears, plus 3 percent of the outstanding credit to countries that are in good standing and are currently servicing their debt to the Fund. For the second question, my own view is that we should try to reach that level sooner rather than later, particularly in view of the prevailing climate of low rates of charge. I hope and presume that protracted arrears will fall, and we will then find that the total level of these balances will decline, but we will always maintain in addition the 3 percent ratio. It seems to me reasonable to continue to add to total reserves plus SCA-1, as we do now, until we achieve our target. We could achieve that target in less than two years, keeping in mind the 3 percent that would have to be applied to any new net outstanding credit, as well as any rise in protracted arrears that would have to be provisioned against.

Mr. Sirat commented that he was not sure whether SCA-2 could be excluded from the formula used to calculate precautionary balances. Certainly, SCA-2 was of a different nature than SCA-1 or the GRA, but there was some overlapping of resources. For example, SCA-2 covered resources to be taken from the GRA for countries presently in arrears, such as Zambia.

Mr. Waterman remarked that if, as Mr. Sirat had implied, SCA-2 covered the encashment of rights earned under rights accumulation programs, the arrears of countries covered under SCA-2 would have to be excluded from total credit outstanding in calculating ratios of precautionary balances.

Mr. Smee explained that, in proposing a formula to determine the needed precautionary balances, he had aimed to avoid double counting or overprovisioning by attempting to take into account the somewhat extraordinary circumstances of the countries covered under SCA-2. It was in any event to be hoped that the countries concerned would soon repay their purchases under their rights accumulation programs, leaving a situation in which no country was in protracted arrears and the only risks to be considered were those arising from countries that were servicing their outstanding debts to the Fund.

Mr. Fernando stated that he had great difficulty in envisaging SCA-2 as something that should be kept separate from the general precautionary balances. Unlike SCA-1 balances, balances under SCA-2 were returnable only after all the outstanding credit extended to rights program countries had been repaid to the Fund. Upon full repayment, the credit balance of the countries that had availed themselves of rights programs would be zero--which was not the case for countries covered under SCA-1.

The Treasurer said that there was a case for excluding SCA-2 from the total precautionary balances because it was a highly specific ex ante provisioning. However, if SCA-2 were to be excluded, the credit outstanding to the one country that was already being fully provisioned against under the SCA-2--Peru--would have to be subtracted from the amount of total credit outstanding. SDR 640 million would thus have to be subtracted from both sides of the calculation.

Technically, it was somewhat premature to assume that Zambia's follow-up exposure would be covered solely under SCA-2, the Treasurer added. The mix of financing for Zambia had not yet been determined. Some of that exposure could be covered through SCA-2--to the extent that the encashment of rights was financed by the use of GRA resources--but a portion could also be covered by the ESAF Reserve, in view of Zambia's ESAF-eligible status.

Mr. Sirat observed that, based on the Treasurer's clarification and the data contained in Table 2, Attachment VII, the Fund's current level of precautionary balances lay somewhere between SDR 2,231 million--total reserves plus SCA-1--and SDR 2,840 million--total reserves plus SCA-1 and SCA-2. His guess was that the actual level was closer to the latter than the former.

Mr. Smee remarked that the Board would need to rely on the expertise of the staff for guidance in determining the current level of precautionary balances. Clearly, as Mr. Sirat had suggested, if the current level included a portion of SCA-2, the Fund had either already attained the desired level or was closer to that goal than if SCA-2 were excluded entirely.

Mr. Al-Tuwaijri made the following statement:

At the outset, I would like to compliment the staff on preparing a highly informative and interesting paper. However, after reading it, I find that the arguments presented in the paper have reinforced the position of this chair during the June 1993 discussion on the Fund's precautionary balances.

I fully share the view that the Fund should continue to aim at a level of precautionary balances that fully covers the credit outstanding to members in protracted arrears. Furthermore, the assessment of the adequacy of precautionary balances should take into account the extent to which those members have adopted adjustment programs to solve their arrears problems and meet their current obligations to the Fund as they fall due. However, I do not believe that it would be appropriate for the annual review of the adequacy of the Fund's precautionary balances to be based on a formal and mechanical approach to risk assessment.

Our best insurance against possible future arrears is the quality of our programs and the adequacy of their conditionality. Thus, while I find it appropriate that we consider risk associated with credit outstanding, any change to our current practices risks sending precisely the wrong signal to the international financial community. It is true that we are assuming a greater amount of risk through increased involvement in programs that have a less stringent conditionality. However, such programs are intended to be a temporary response to exceptional circumstances. Countries making use of the systemic transformation facility, for example, are expected to graduate to stand-by or extended arrangements. Changing our policies now may signal changes in general program policies. My concern here is that this may provide a temptation to become involved, or to be perceived as being involved, in financing at levels beyond those appropriate under the catalytic role of the Fund.

Because the Fund uses conditionality as its insurance against future arrears, we are implying that the risks to the programs are mainly exogenous, namely, they are based mainly on factors that are not specific to the country in question. Certainly, there are endogenous risks associated with countries undergoing wholesale

transformations of their economic systems. However, if we start building precautionary balances to guard against these risks, we cannot avoid the perception that we are relaxing our standards of quality of programs and conditionality, including close monitoring.

The staff presents a highly informative discussion on the determination of precautionary balances by official bilateral creditors, commercial lenders, and other international financial institutions. With regard to the former, and despite whatever elaborate schemes may or may not exist, the sentence in the staff paper that is most telling is that there is always the potential that "economic evaluation would be outweighed by political considerations." For this very last consideration, the experience of bilateral official creditors clearly is not relevant to our institution. With regard to commercial creditors, their practices are the outcome of the nature of their responsibilities toward their shareholders and depositors. This responsibility is very different from the mandate of the Fund. Furthermore, even in the case of commercial creditors, the staff stresses that risk assessment involves a "broad process of subjective and judgmental evaluation of a variety of factors." In the final analysis, the judgement of commercial creditors is as subjective as ours despite its objective veneer. I am not sure that the experience of other international financial institutions is relevant either, as no other institution has the same mandate as the Fund. The differences are well outlined in the staff paper, but I would stress that the Fund's assets belong to central banks, and we do not resort to capital markets. At the same time, we enjoy a preferred creditor status.

Regarding the level of our precautionary balances, I do not believe that it would be advisable to reduce our current rate of accumulation. This institution has been called upon to meet important challenges, and we all acknowledge that it is taking new risks. Of course, our current rate of accumulation of precautionary balances is not sacred. Like Mr. Prader, I believe that we should not be continuously biased in the direction of increasing reserves.

In sum, I believe that our current practices have served us well. Overdue repurchases have declined, our strengthened arrears strategy is working reasonably well, and the ratio of precautionary balances to overdue repurchases is at a comfortable level of 130.2 percent. Furthermore, our precautionary balances are increasing at a compounded rate. Although I admit that this rate is arbitrary, I believe that the judgments that we make under a systematic risk-assessment system will be equally so. Ultimately,

the main difference between what we are doing now and what we could do under a formal or mechanical approach to risk assessment, is that the latter approach risks undermining the credibility of our conditionality and our catalytic role.

Miss Vori made the following statement:

I would like to begin my comments with two general observations. First, while important steps have been taken to improve the Fund's policy on credit risk through the adoption of the strengthened cooperative strategy, larger elements of uncertainty remain. In particular, this institution will be called upon in the near future to support economic programs with a high degree of structural content--for instance, in countries engaged in the process of transition to market economies. Considerable risks could arise with regard to the timely repayment of these loans. This calls for an evaluation of the adequacy of the level of precautionary balances, which not only serve prudential considerations but also permit increased flexibility of the Fund's lending. Second, frequent changes in the economic situation may occur that would warrant a periodic reassessment of the adequacy of the policy in place.

Let me add further that I fully agree with Conclusions A and B regarding burden sharing. With regard to these, I believe that the technical criteria can be defined by the staff in a noncontroversial manner. However, as stated by this chair in a previous discussion, the level of precautionary balances must be considered in relation not only to outstanding but also to foreseeable credit risk. Therefore, some provisions need to be made to cover the potential risk of losses related to the fact that members presently current with payments may be unable to meet future obligations. Accordingly, I also support Conclusion C, which highlights the need for the Fund to develop a policy that will systematically provide for risk assessment regarding such credit, and on the basis of such assessment to take appropriate action as regards the level of the Fund's precautionary balances. Of course, I am fully aware that the matter is very complex and sensitive, owing to the high degree of judgment involved in the methodology of risk evaluation and the danger of possible disclosures of the assessment of a country's risk. Nevertheless, I believe that most elements for an analysis of a country's ability to meet its obligations could be collected, also in the context of a general evaluation of surrounding economic circumstances.

As suggested in the staff paper, the discussion of reports for Article IV consultations in the Executive Board could provide

a first basis for evaluating the current situation and prospects of member countries with outstanding debts to the Fund. The staff could thus proceed to make an assessment of Fund exposure to risk on an aggregate level, taking into account all the relevant factors. Among these, a country's rating in secondary markets could also play an important role. A crucial factor to be considered would be also the inherent risk in collecting outstanding credit over the medium term and the concentration of credit exposure within a country, which is per se an element in determining additional risk.

In sum, the determination of the adequate level of the Fund's precautionary balances would be made up of two components. The first aims to cover fully the credit outstanding to members in protracted arrears, while the second reflects an evaluation of the risk of loss associated with Fund outstanding credit vis-à-vis countries presently current on the basis of an assessment of the credit risk of the larger users of Fund resources. The staff's finding will have to be presented in an aggregate form. In this respect, a basket-based provisioning presentation could help to overcome the difficulties involved in disclosing the credit rating attached to each country. On the basis of such an approach, the staff could make a proposal on the target amount of precautionary balances, founded on the assessment of the risk associated with outstanding Fund credit, as well as on the judgmental adequacy of current balances with respect to foreseeable exposure of the Fund.

It is understood that the review of risk exposure and evaluation of the Fund's precautionary balances would have to be undertaken periodically by the staff. Therefore, I agree with Conclusion D, which provides for an evaluation of the Fund's policy in the context of the annual review of the Fund's income position.

Mr. Dlamini made the following statement:

I would like to join other Directors in commending the staff's efforts to address objectively the difficult issue of the Fund's precautionary balances. It is interesting to note in the staff paper that the majority of the other official lenders surveyed by the staff do not have a standard policy of procedure in place for assessing the risks likely to arise in connection with providing credit to sovereign borrowers. Equally interesting is the fact that the reserve policies of the Fund appear to be more conservative than those of other lenders, which normally provide coverage for only part of the obligations outstanding to countries in nonaccrual status.

Turning now to the substance of our discussion, I agree that protection against the risk of loss is essential for any lending institution. Precautionary balances have served this purpose in the case of the Fund, and I concur with the staff that maintaining sufficient precautionary balances should continue to serve as a general operational guideline for the Fund. In this regard, it is noteworthy that the level of protracted arrears has been reduced from a peak of about SDR 3.52 billion at end-1992 to SDR 2.97 billion at end-1993 and that total credit outstanding to members in protracted arrears is now more than fully covered by the precautionary balances already accumulated. This is a strong indication that a slower pace of accumulation of these balances might be appropriate. The situation could, of course, change if newer risks emerge or additional arrears are accumulated and become protracted. This position obviously differs from the suggestion made by the staff, namely, that additional precautionary balances are needed to cover possible arrears cases in the future.

I do not believe that it is appropriate now to go considerably beyond the present policy of covering the risk associated with credit outstanding to members in protracted arrears. In the first place, as indicated, the precautionary balances already accumulated are in excess of the level required to cover the risks posed by members currently in protracted payment arrears. Moreover, there is no certainty that members that are now current in meeting their obligations to the Fund will fall into arrears. Any effort to project future risks would be misleading and could result in an unwarranted increase in the rate of charge. As is well known, the Fund's operational income is derived mainly from periodic charges to the users of its resources. While Fund charges are at below-market interest rates, they nevertheless impose a heavy burden on the borrowing members, and any action that increases the precautionary balances would raise even further the burden of the users of Fund resources, many of which are developing countries. In fact, it would appear reasonable, in view of the level of the precautionary balances already accumulated, to lean on the side of retaining the concessional element of the rate of charge by either avoiding any further accumulation or by slowing the pace of accumulation. The fact that protracted arrears have recently fallen should serve as a good indicator of the Fund's success in containing its exposure.

The catalytic role of the Fund in facilitating the provision of both debt relief and additional financing to its members, the weight that the Fund attaches to the quality of adjustment programs, the mechanisms of assessing members' capacity to repay the Fund before arrangements are approved, the Fund's preferred

creditor status, and the strengthened arrears strategy are all very important additional safeguards against the risk of future arrears.

Moreover, the present policy of reviewing annually the level of precautionary balances provides the Board with a useful opportunity to take the required remedial measures in good time.

Mr. Waterman made the following statement:

I would also like to thank the staff for a good paper which has been very helpful to our discussion. Although Mr. Prader has always struck me as a rather solid and responsible citizen, I must say that I have a feeling bordering on irresponsibility in agreeing with much of his statement. It is important to recognize that one can overprovision as well as underprovision, and, if anything, I suspect that we are more likely to do the former rather than the latter. However, I admit that this is very much an instinctive feeling on my behalf.

Mr. Jiménez de Lucio made an interesting point, namely, that over the past fifty years, the Fund's track record has been exemplary. As I understand it, we have not lost a nickel in fifty years. We certainly have a few problems coming down the pike--such as the case of Sudan, for example--but the track record is certainly an impeccable one. Clearly, that relates to the nature of Fund-supported programs and the incentive structure, which has been strengthened in recent years. Thus, my expectation is that losses should remain relatively low, because a country in extended arrears or being expelled from the Fund has significant implications for borrowers that they generally wish to avoid. There is general agreement that is also important that we do not provision in a way that results in a more relaxed attitude to either lending or borrowing.

I agree that we should have precautionary balances to fully cover protracted arrears. How much more is needed in addition to that is a matter for judgment, but in arriving at any more general provisioning, it needs to be recognized that we have provided more than enough to cover the main risks--namely, those members that are in extended arrears. I could live with an approach of adding additional precautionary balances of 3-5 percent of credit outstanding, excluding extended arrears, and, if I understand Mr. Dorrington and Mr. Schoenberg correctly, we already have balances equivalent to about 4 percent of such credit outstanding. On the basis of the numbers that we have in front of us, there does not seem to be a pressing need to augment these balances at the moment.

I do not have any problem with analyzing the liabilities of the Fund periodically in ways that have been suggested by the staff, but I do not believe that we should be driven mechanically by the results of such an analysis. As I read the discussion this afternoon, I believe that there is a fairly general consensus on that point.

At the end of the day, any losses of the Fund will be borne by the membership. We know that reserves can be built up quickly and are already quite high, so I am reluctant to impose any additional burden on borrowers in advance of a further demonstrated need.

Mr. Wei made the following statement:

I would like to join the previous speakers in highly commending the staff for preparing such a comprehensive paper on this difficult and complex issue. I broadly agree with the staff's factual findings and realistic analysis of the practices widely adopted by other institutions, as well as with its analysis of the Fund's experience in this regard.

The staff's thorough comparison is helpful in designing the Fund's own precautionary balances policy. This survey's most valuable conclusion is probably that the Fund cannot duplicate any exiting convention or procedure. As an international financial cooperative institution, one of the Fund's fundamental responsibilities is to support, through its lending facilities, members' adjustment efforts when they experience balance of payments difficulties. After carefully reading the review of other institutions' experience, I also share the staff's view that policies regarding the accumulation of precautionary balances and the relevance of the reserve accumulation policies must be considered against a different backdrop, taking the Fund's unique considerations into account.

In principle, I am of the view that the Fund's precautionary balances should aim only at covering the outstanding credit to members in protracted arrears, because this situation presents an actual threat to the soundness of the Fund's assets--which should be protected promptly should this happen. In this respect, I believe that--at a ratio of credit to arrears of 111.2 at the most recent review of this issue--the level of precautionary balances that the Fund has maintained to cover the risk of protracted arrears has proved sufficient.

On the issue--extensively addressed in the paper--of whether the Fund's precautionary balances should provision for those

members current in their payments to the Fund, this chair takes the view that the Fund's financial security relies mainly on a well-designed economic adjustment program and timely and frequent reviews of program implementation. Furthermore, the staff always analyzes carefully the borrowing member's capacity to make payments to the Fund; therefore, I do not think it necessary or appropriate to set up the Fund's precautionary balances in relation to total outstanding credit. In this connection, I share Mr. Prader's view. Meanwhile, we cannot support any policy intention to base the Fund's reserves on locating particular groups of its members and building up lending reserves for them in advance.

On the issue of how to determine the desirable level of precautionary balances, we believe, like other Directors, that the current levels are adequate.

In addition, I should underscore the importance and necessity of continuously strengthening the extended analysis of the purchasing country's capacity to repay that is incorporated in the review of its program, and of persevering with the strengthened cooperative strategy aimed at eliminating the overdue financial obligations to the Fund. This strategy has proved successful in reducing the amount of arrears and the number of members in arrears.

With regard to the annual review of the precautionary level, I fully agree that in view of the importance of this matter, it would be necessary to make an analysis of the Fund's exposure to risk associated with the financial assistance that it provides to member countries. However, only the aggregate results of the countries in protracted arrears should be generated as a basis for discussion on the need to change the level of these balances.

As to the value of the gold held by the Fund, I understand the staff's explanation that valuing this gold according to market terms is a complex issue. However, it is necessary to pay due attention to the issues involved if the market value of the Fund's gold assets is to be recognized.

In view of the uncertainty and unpredictability of the precautionary balances, I can go along with the staff's conclusion that the target amount of the balance should be adjusted periodically, say annually, to cover in a timely manner the present and foreseeable exposure to risk.

Mr. Fayyad made the following statement:

The staff has provided us with an informative paper for today's discussion. Let me summarize our views on the main issues raised in the paper.

First, the considerations underlying the policies and practices of MDBs regarding the assessment of sovereign risk bear greater relevance to the Fund than do those of official and commercial lenders. However, as noted by the staff and by most of the speakers already, the relevance of the reserve accumulation policies of the MDBs as a guideline for the Fund must be tempered by the institutional and other differences between the MDBs and the Fund, in particular the differences in financial structures and internal financing arrangements.

Second, an important aim of today's discussion is to come to a view on a framework within which the adequacy of the Fund's precautionary balances may be evaluated. Ultimately, the judgment on the adequacy of these balances must be linked to the arrears situation. An important question, of course, is which arrears--existing or possible future arrears? In view of the policies that govern the use of Fund resources and its policy on arrears--and here I have in mind, among other things, the time factor referred to by Mr. Autheman, namely the "time before these problems become effective"--the level of credit extended to members in protracted arrears should in our view be a sufficient basis for judging the adequacy of precautionary balances. Thus, we can agree with the policy of precautionary balances aimed at full coverage of total credit extended to members in protracted arrears. This is more than most lenders do in respect to borrowers with overdue obligations, as most lenders aim at full coverage of protracted arrears, rather than coverage of the total credit extended to borrowers in protracted arrears. Most of the lenders do take into account the risks of loss associated with credit to borrowers that are current in their payments; however, as indicated by many speakers, the Fund is not like most lenders.

In addition to the safeguards associated with the Fund's policies on the use of its resources, the Fund enjoys a preferred creditor status, and the central role that it plays in catalyzing financial flows to past and current users of its resources significantly reduces its financial risks. The Fund also has a substantial amount of hidden reserves.

Third, we are not in favor of basing decisions on the adequacy of precautionary balances on considerations that go beyond aiming at full coverage of credit extended to members in

protracted arrears. Therefore, we do not support any of the alternatives considered in the paper regarding the possibility of a generalized risk assessment and the accumulation of balances on the basis of such an assessment.

Fourth, aiming at full coverage of total credit extended to members in protracted arrears should not in principle apply to credit that is not yet due to members that are following Fund-monitored programs.

Fifth, as a policy of a generalized accumulation of precautionary balances, is not, in our view, called for, or even appropriate in the case of the Fund. The drawdown of accumulated balances in the event of a write-off should not be followed by a replenishment of those balances.

Finally, the adequacy of precautionary balances may be reviewed by the Board in the context of the annual reviews of the Fund's income position or sooner, if warranted by developments. As noted by the staff, as well as by other speakers, credit outstanding to members in protracted arrears is now more than fully covered by precautionary balances.

With this in mind, we hope that the forthcoming review will provide an opportunity to take a hard look at the net income target. It may be recalled that the net income target was first established in fiscal year 1982 at 3 percent of reserves and was raised at the beginning of fiscal year 1986 to 5 percent as part of the Fund's response to the then growing problem of arrears. The Fund currently has a comfortable cushion of precautionary balances, and considerable progress has been achieved under the arrears strategy. In these circumstances, I believe that the time is right--and it has been for some time--to ask why members least able to do so should continue to be required to add in the course of the next year to the shareholders' equity of all members of this institution.

*Mr. Kafka made the following statement:*

I would also like to thank the staff for an extremely useful and illuminating paper. Although the staff paper usefully explores the approaches of other institutions, it has, perhaps, on this occasion even more coherently put before us all of the factors that the Fund and the Board have implicitly and explicitly taken into consideration in assessing the risk of program failures and the risk of ultimate loss. The process of risk evaluation in the Fund has necessarily been an evolutionary process, in particular over the past ten years. The more extensive analysis

of a country's capacity to repay provides a good basis for making judgments about the risk of loss at the time of extending credits. The paper also notes that appropriate surveillance should alert the Fund when different or increasing risks are emerging during the course of a program with a member.

The paper notes the importance of surveillance and of assessment prior to extending credit, as well as of preventive measures in the design of programs. It has been our experience that the staff does not bring unacceptable risks to the Board for consideration. If very high-risk cases are in prospect, the Board may wish to make an assessment of some specific reserve for that case.

In general, however, we would support the position that the cases of extreme difficulty would tend to be single countries--not groups of countries--and that those members would tend to have not just financial problems but also political and social problems that may be difficult to predict. A generalized system of rating would therefore not be appropriate. In respect of unpredictable problems that may arise, we would not rule out the principle--I stress, the principle--of a forward-looking building of reserves against all Fund credit outstanding, which is indeed truly precautionary. A two-tier approach may therefore be considered: a total reserve cover for protracted arrears, as we have now; and a small ratio of cover for general risks that may have increased.

But, even under this approach, and considering our preferred creditor status, the Fund appears by all accounts to have more than sufficient reserves for the purpose, and we find no merit in advocating an increase at this time. In fact, we would not object to Mr. Ismael's conclusion, if I have correctly understood him, that precautionary balances--beyond full coverage of credits to countries in protracted arrears--could be reduced. It is, however, appropriate that the Board retain an annual review of the precautionary balances in order to reassess whether there are new specific risks to be provided for or whether any changes in the global economic environment might affect the need to adjust the general reserves. I do not believe that we would be helped in our assessment by any particular system of choice of data or presentation. Let the staff put before us what it considers relevant.

Mr. Marino made the following statement:

Like previous speakers, we thank the staff for its efforts to establish a framework for assessing the adequacy of the Fund's precautionary balances. We are reassured by its findings, the

main one in our view being that the Fund's reserves are quite adequate to cover the risk faced. This is true in looking at the quantitative indicators, and it is certainly reinforced when looking at the qualitative indicators, particularly the link that exists between the use of Fund resources and the adoption of strong adjustment programs by member countries. Additionally, the phasing of purchases, program reviews, and quantitative performance targets are all elements that serve to safeguard the resources of the Fund. Moreover, Mr. Autheman very eloquently reminds us in his statement that the Fund is not a commercial lender but a cooperative financial institution that is endowed, unlike any commercial lender or MDB, with extraordinary powers to ensure that members fulfill their obligations, and that this is our best protection, helping to keep the rate of charge at relatively low and uniform levels.

We continue to believe that the amount of precautionary balances that the Fund should hold has to be evaluated in the context of the cost of accumulating such balances and the distribution of such costs among the membership. In the end, the entire membership is responsible for the lending decisions of the institution. The current system of reserve accumulation and, in general, of a buildup of precautionary balances, places the thrust of the burden on users of Fund resources. As long as this system is in place, and in view of the overall assessment of adequacy--or, I might say, overadequacy--of reserves, we would oppose any action or decision that leads to a faster pace of reserve accumulation.

We share the concerns expressed by Mr. Prader and many other previous speakers about using certain mechanistic criteria when trying to assess the adequacy of the Fund's reserves. It risks giving a wrong signal to the outside world--whether with respect to individual countries or the effectiveness of Fund policies. In our view, the disadvantages of any of these approaches outweigh any advantage of greater precision in assessing the adequate level of precautionary balances.

Let me turn briefly to the main conclusions of the staff analysis. We mainly concur with Conclusions A, B, D, and F in paragraph 80, which, in our understanding, preserve and strengthen a successful and pragmatic approach to determining the adequacy of the Fund's precautionary balances. However, we would add to Conclusion C that in establishing the desirable level of precautionary balances to provision against a risk posed by members current in their obligations, due account should be taken of the gold holdings of the institution and the security that this represents for the Fund's subscribed assets. Mr. Dorrington said

that a zero risk cannot be attached to the members that are current in their payments to the Fund, and we would add in a symmetric fashion that we could not accept that a zero weight be given to the Fund's gold holdings as a precautionary asset.

Regarding Conclusion E, we consider that the best approach on which to base the annual review of the adequacy of Fund's precautionary balances is a broad judgmental approach. As Mr. Kafka said, the staff could forward all the relevant factors--one would look certainly at total credit outstanding--and take into account the level of precautionary balances in relation to members' protracted arrears, as well as other elements, such as hidden reserves and the unique nature of the institution.

Mr. Fernando made the following statement:

At the June 1993 discussion, like most others, this chair endorsed the need to steadily build up precautionary balances, including reserves. Many policies have a bearing on precautionary balances, and, with a view to ensuring their adequacy, we reconfirmed then the need for annual reviews. In concluding that the balances were more than adequate to meet the risk of outright loss, we were also mindful that these balances have a wider role to fulfill as a safeguard against deficits in income or as a source of additional liquidity free of interest.

The present paper tends to address a broad range of concerns expressed previously, and we thank the staff for its response. The policies that have evolved in the Fund reflect its unique character--something that I heard very strongly today--and the Articles of Agreement should be the bedrock on which to develop our practices. The paper, as expected, provides important insights as to why policies relating to sovereign lending--by member governments or by market-based financial institutions--are not suited to this institution and why the so-called generally accepted accounting standards cannot be applied as rigidly to the Fund as to profit-seeking institutions.

Despite the wealth of material presented by the staff, we are not persuaded that our present policy needs change. The staff has set out various criteria to assess risk. Without going into details relating to the technical merits of the methods of risk assessment, I would in general say that we have difficulty with the case-by-case approach to estimate the need and the level of precautionary balances. This observation, of course, applies to credits that are not in nonaccrual status. Even if the label is different, we see this as a loan loss provisioning in respect of specific members. I may also recall that it was after an intense

debate on provisions in 1986 and 1987 that decisions were then taken to further build up precautionary balances against risks of a general nature.

Moreover, an approach based on an analysis of country risk raises an issue of confidentiality. As the Fund's role is that of a catalyst, we must be particularly mindful that its unique ability to obtain all relevant information from a member is not impaired. Besides, the Fund, unlike other institutions, has developed policies such as the contingency and compensatory financing facility to address likely economic risks, while also spending large staff resources for close monitoring of performance, including preventative and deterrent measures under the strengthened arrears strategy.

Most important, the Fund's oversight over the macroeconomic picture gives it an aid to assist members if things are turning out wrong. Of course, things can turn out wrong--that is why we have a forward-looking policy of reserve accumulation, as well as the Special Contingent Accounts. Precautionary balances, including reserves, at their current level more than fully cover all credit outstanding in protracted arrears cases, and in relation to total Fund credit outstanding they amount to well above 10 percent.

No one has disputed the favorable results of the strengthened cooperative strategy, and we have no reason to expect that an episode of this nature will be repeated in the future, to the extent that we adhere to the letter and spirit of the preventative and deterrent elements of our strategy.

As a final note, as suggested by Mr. Schoenberg, we believe that as part of our future work we should consider scope for upgrading the quality of SCA-1 by eliminating its temporary character and making it as permanent as the general and special reserves.

Mr. Mirakhor made the following statement:

I join other Directors in their appreciation of the staff paper. Like Mr. Prader and Mr. Autheman, we consider that the combination of the Fund's preferred credit status, present relatively high level of reserves, strengthened arrears strategy, highly undervalued assets, quality of programs, and annual review of present precautionary balances provides for a more than prudent policy of protecting the Fund. Hence, along with other Directors, we regard the current level of precautionary balances as more than

adequate. Moreover, as Mr. Ismael has pointed out, the rate of accumulation is extremely high.

Considering the arguments of the paper, as well as those of other Directors, we believe that the present approach to determining the adequacy of the Fund's precautionary balances is appropriate. Setting aside our concerns regarding the present burden-sharing mechanism, we agree with Mr. Prader's assessment that the present approach has been both pragmatic and successful.

Mr. Posthumus remarked that, although a number of Directors had emphasized that the Fund should not be compared with other multilateral creditors because of, inter alia, its preferred creditor status, strong conditionality, and good track record, the information presented in Table 1, Attachment VII suggested that the Fund was perhaps not such a risk-free institution as had been envisaged. During the 1988-92 period, the Fund had a larger proportion of nonaccrual credits to total credit--or, in Fund terminology, of arrears to total outstanding loans--than either the World Bank, the Asian Development Bank, the Inter-American Development Bank, or the African Development Bank.

The Treasurer observed that, although the difficulties involved in quantifying the concepts made the current discussion somewhat unsatisfying from an intellectual point of view, the analysis of precautionary balances had major implications for the functioning of the Fund as a financial institution. The Fund's precautionary balances were closely linked with such issues as burden sharing, the cost of Fund credit, the Fund's income position, and the rate of charge on the use of its resources. The paper under discussion had thus been prepared with the aim of illuminating those linkages and helping to build a consensus in the Board on those controversial issues.

The first incidence of arrears in 1984 had dramatically changed the culture of the Fund, the Treasurer recalled. Before 1984, there had been no expectation of arrears; reserves had been built up slowly and systematically throughout the late 1950s and 1960s, but only for income preservation purposes, that is, to meet possible administrative deficits. However, the onset of arrears had triggered both the successful implementation of the Fund's strengthened arrears strategy and the systematic assessment--in considerations of requests for the use of Fund resources--of borrowing countries' capacity to repay the Fund. As a consequence, the Fund's reserves had accelerated sharply.

The evidence clearly indicated that, even if the Board had not yet reached consensus on the principles underlying the appropriate sign in the Fund's precautionary balances, the strategy followed by the Fund since 1984 had been successful, the Treasurer commented. Since then, the volume of Fund credit outstanding had fallen by 19 percent while reserves had

increased by 107 percent. Since 1990--when credit disbursements had begun to rise again after a period of large repurchases--Fund credit outstanding had increased by 17 percent while precautionary balances had strengthened by 37 percent. Moreover, the projected rates of increase for reserves and credit disbursements on a net basis for fiscal year 1994 indicated that reserves would account for about 15 percent of the increment of Fund credit outstanding, with reserves rising by about SDR 350 million and outstanding Fund credit by about SDR 2.6 billion.

Other figures shed light on the adequacy of the Fund's reserves, the Treasurer added. First, the ratio of total precautionary balances to total credit outstanding was 11.4 percent. Second, excluding countries in arrears--but including Peru in both the numerator and the denominator--the ratio of free reserves plus SCA-2 to total credit outstanding was close to 4.7 percent. Finally, excluding SCA-2 and the credit outstanding to countries provisioned against under SCA-2, the reserves-to-credit ratio was almost 2 percent.

Since 1984, the Fund had been accumulating reserves rapidly, the Treasurer remarked. Admittedly, a quick glance at Table 1, Attachment VII might suggest that the World Bank was doing a much better job in that respect: in fiscal year 1993, its proportion of precautionary balances to total credit outstanding had risen to 16 percent, compared with the ratio of 10 percent for the Fund. However, it should be emphasized that, in accordance with the instructions of World Bank Directors, only 3 percent of that total of 16 percent was accumulated specifically to protect the Bank against the risk of loss.

The World Bank's remaining precautionary balances had been stored in three other accounts, the Treasurer explained. The first account--no longer operational--was a special reserve account valued at about $350 million, which the World Bank had established in 1984 as a safeguard against overdue obligations. The other two accounts served the useful purpose of financing World Bank operations. The balances in those accounts had been accumulated to limit the World Bank's need to borrow on the capital markets during periods of high interest rates. These accounts did not serve the same purpose as the Fund's precautionary balances. That qualitative difference explained why the ratio of precautionary balances total credit outstanding was lower in the Fund than in the other institutions.

The World Bank--and, to a large extent, the other MDBs--had developed precautionary balances in the form of reserves to maintain its earning power, the Treasurer continued. The World Bank's earnings, which were essential to its capital market operations, had tapered off in recent years, as the loans that it had made in the 1960s and 1970s at very advantageous rates of interest and exchange had been paid back by borrowing countries.

With respect to coverage, the principle of covering a percentage of total credit outstanding could be justified more easily than the principle--espoused by a number of Directors--of fully covering protracted arrears, the Treasurer suggested. Full coverage of protracted arrears was in one sense an extremely conservative objective. If that principle were being observed, for example, Sierra Leone's protracted arrears to the Fund would have been covered by precautionary balances up until 10:02 a.m. on Monday, March 28, 1994; at that time, however--with the Board's approval of arrangements under the ESAF for Sierra Leone--those balances would have become unnecessary. Moreover, other countries that were embarking on ambitious adjustment programs, such as Cambodia, Viet Nam, and Zambia, had been in protracted arrears to the Fund at various times.

For the sake of symmetry--and to give a clearer picture of the risks facing the Fund--the proposed weighting of the risk associated with members current in their repurchases should thus be balanced by a weighting of the risk associated with members in protracted arrears, the Treasurer considered. Determining the optimum ratio of precautionary balances to total credit outstanding would be difficult; in that connection, however, it was important to remember that, as one speaker had noted, the Fund had not yet lost a nickel--or, more accurately, an SDR--on outstanding credit. Also, the implementation of the strengthened arrears strategy and the adoption of the mechanism to assess members' capacity to repay the Fund provided important additional safeguards against the risk of future arrears.

In assessing the adequacy of the Fund's precautionary balances, the staff had attempted to measure the risk of future arrears by dividing the debtor countries into three broad classes, the Treasurer recalled. Basing such an assessment on more than three categories, as one speaker had proposed, had the drawback of facilitating the identification of the individual countries, as most of the Fund credit outstanding was accounted for by a relatively small number of countries.

Mr. Dorrington said that, under his scheme for measuring the risk of future arrears, the Board would never be told the total amount in each category--and certainly not the risk assigned to individual countries. The Board would be informed only of the weighted sum. Moreover, only those staff directly involved in the calculations would have access to the total amount in each category.

In addition, using more than three categories to measure risk might actually make it easier to shield the identity of the individual countries, Mr. Dorrington suggested. The movement of a large debtor country from one group to another would be easier to hide if there were 11--rather than 3--categories involved.

Mr. Sirat said that he did not understand why it was necessary to group countries into intermediate categories in assessing the risk of arrears.

The staff could simply present an aggregate risk assessment to the Board based on the situation of the individual countries.

Mr. Schoenberg remarked that a number of Directors who favored coverage of credit to Fund members who were not in arrears seemed to be under the erroneous impression that a substantial increase in the rate of reserve accumulation was needed to attain that goal. In reality, if the current 4 percent rate of accumulation were increased to 5 percent or 6 percent, the credit extended to members not in arrears could be adequately covered in a few years. At the same time, many Directors who felt that the precautionary balances should not cover the credit extended to countries not in arrears had also--inexplicably--called for a continuation of the current fast rate of reserve accumulation.

If it were to be decided to set aside reserves to cover the Fund's exposure to countries that were not in arrears, the amount of those reserves should not be determined by analogy to the coverage extended to the countries in arrears, Mr. Schoenberg considered. As the Treasurer had explained, it was somewhat difficult to get a handle on the amounts involved in the latter situation. A separate yardstick would therefore be needed to measure the coverage of credit to countries not in arrears.

Mr. Fayyad commented that, with respect to Mr. Schoenberg's final point, although some Directors might feel uncomfortable in using the credit extended to members in protracted arrears to determine the adequacy of precautionary balances, they would still have to admit that the former amount was known with certainty.

Mr. Posthumus remarked that, with respect to the Fund's track record, it was technically true that nothing--neither a nickel nor an SDR--had ever been lost. However, it should not be forgotten that the prospects of recovering some of the Fund's outstanding claims were far from bright.

The Treasurer noted that, with respect to quantifying the risk of arrears, the crux of the problem--and the focus of the discussion--lay in establishing principles for weighting the risk associated with loans to countries and groups of countries.

Mr. Newman added that, by setting aside 100 percent of the precautionary balances for the existing arrears and factoring in a 4 percent growth rate to cover other credit, the Fund had implicitly made a judgment that the aggregate risk of arrears was 25 to 1. The point of the present exercise was to analyze both the numerator and denominator of that ratio and determine whether--and, if so, how--it should be adjusted.

The Treasurer said that, with respect to Mr. Posthumus's observation, it was true that if a member left the Fund, the Fund's balance sheet claims could become worthless if no agreement could be reached on the settlement of

outstanding claims. However, in the rare cases in the past when members had been expelled from the Fund, claims were fully settled over time.

Mr. Marino said that he agreed with Mr. Schoenberg that a more systematic assessment of the Fund's precautionary balances should not automatically lead to an increase in the pace of reserve accumulation. However, he had the impression that just such a linkage existed in the minds of many of the advocates of a systematic assessment.

The Acting Chairman made the following concluding remarks:

> Executive Directors indicated that they found the discussion on the Fund's precautionary balances very useful. They generally welcomed the staff paper as corresponding well to the issues and concerns raised in the June 1993 discussion on the subject. It could not have been expected that all of the issues would have been resolved today--indeed, the discussion exhibited a range of perspectives on the adequacy of the precautionary balances and the approach to be followed in assessing the adequacy of those balances--but there was progress in clarifying Directors' views on some of the issues involved and the direction in which the Board might want to go in determining a policy on precautionary balances. These issues will have to be revisited in June 1994 in the context of the annual review of the Fund's financial position in order to determine the net income target and the rate of charge for fiscal year 1995, and, it was also suggested, in future discussions on burden sharing.
>
> Directors found the summary of the practices of other sovereign lenders and multilateral development banks revealing and helpful to their own thinking, although, as most speakers emphasized, there were important structural differences between these institutions and the Fund.
>
> As to the Fund's policy on the level of precautionary balances, there was no disagreement that the Fund should continue to aim for a level of precautionary balances that was sufficient to cover credit outstanding to members in protracted arrears in the General Resources Account. In that context, a number of Directors noted that, following the sharp increase in protracted arrears in the mid-1980s, the Fund had adopted policies to resolve this problem--the strengthened cooperative strategy--and had taken steps to increase its precautionary balances substantially. It was pointed out that these overdue obligations were now amply covered, as precautionary balances represented some 125 percent of overdue repurchases in the General Resources Account.

Directors were generally agreed that the most important safeguard for the Fund's assets was the adjustment policies of member countries making use of Fund resources. To the extent that these adjustment policies succeeded in their goal of resolving members' balance of payments difficulties, there would normally be no question of members' meeting payments as they fell due to the Fund. Moreover, a number of Directors emphasized that additional protection was to be found in the Fund's preferred creditor status.

However, Directors pointed out that there nevertheless remained some residual exposure to risk of loss, which should be taken into account in judging the adequacy of the Fund's precautionary balances. In this respect, most Directors favored the more generalized approach, which would relate the need for precautionary balances to the amount of total credit outstanding. However, the proportion of total credit that it would be desirable to provide for could not be determined with any degree of accuracy on the basis of economic data but, as a number of Directors said, must be very much a question of judgment.

Directors also commented on the adequacy of the current level of precautionary balances in present circumstances. A number of Directors considered that, following the substantial accumulation of balances in recent years, the Fund was now in a comfortable position; some felt that, in view of the impact on the rate of charge, some reduction in reserve accumulation could be contemplated. Indeed, a few Directors questioned whether it was necessary to continue to accumulate reserves, in view of what they perceived as the very high level of reserves. Also, in the view of some Directors, the existence of substantial hidden reserves in the form of the undervaluation of the Fund's gold holdings contributed to the strength of the Fund's financial position and could be taken into account when considering the need for additional precautionary balances.

The view that the Fund had reached a relatively comfortable reserve position, however, was not shared by a number of Directors, who considered that, in view of the expected expansion of Fund credit, it would be prudent for the Fund to continue to build up its precautionary balances at least at the present pace.

As noted, Directors agreed to return to this subject in future Board discussions that had a bearing on the Fund's reserves.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/94/28 (3/31/94) and EBM/94/29 (4/1/94).

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAM/94/45 (3/30/94) is approved.

APPROVAL: October 23, 1995

LEO VAN HOUTVEN
Secretary