DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

February 8, 1996

Approval: 2/15/96

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/52

10:00 a.m., June 8, 1994

Contents

Executive Board Attendance

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	M. Sirat
	D. Desruelle, Temporary
J. Bergo	E. Srejber
H. Evans	J. Dorrington
	D. A. Barr, Temporary
	R. K. W. Powell, Temporary
	T. Fukuyama
K. P. Geethakrishnan	L. E. N. Fernando
	R. Kannan, Temporary
	K.-T. Hetrakul
	Hon C.-W., Temporary
D. Kaeser	R. F. Cippa, Temporary
	W. C. Keller, Temporary
	A. Chang Fong, Temporary
	E. Kouprianova, Temporary
	B. M. Lvin, Temporary
	V. Y. Verjbitski
W. Kiekens	J. Prader
	J. Hamilius, Temporary
	V. Kural, Temporary
G. Lanciotti	N. Coumbis
	M. Giulimondi, Temporary
K. Lissakers	B. S. Newman
	M. A. Brettschneider, Temporary
	J. B. Wire, Temporary
R. Marino	A. Galicia, Temporary
	M. Daïri
	M. J. Mojarrad, Temporary
	H. Golriz, Temporary
L. J. Mwananshiku	B. S. Dlamini
	Y. Patel, Temporary
G. A. Posthumus	
	Y.-M. T. Koissy
	E. Wagenhoefer
	R. von Kleist, Temporary
A. S. Shaalan	Y. Y. Mohammed
	S. K. Fayyad, Temporary
	T. K. Gaspard, Temporary
D. E. Smee	J. Jamnik, Temporary
	R. Rainford, Temporary
	K. J. Langdon, Temporary
E. L. Waterman	A. M. Tetangco, Jr.
Zhang M.	B. Wei

Yang X., Temporary
A. G. Zoccali A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present

IBRD: D. R. Dollar, East Asia and Pacific Regional Office; I. Guerrero, Europe and Central Asia Regional Office. Administration Department: T. Cole. African Department: M. Touré, Director; E. L. Bornemann, Deputy Director; R. A. Franks, J. P. Gordon, E. T. E. Ibrahim, J. Kakoza, L. J. Lipschitz, Y.-F. Lum, C. N. O. Mordi, J. T. Reitmaier, R. C. Williams. Central Asia Department: H. Neiss, Director; B. B. Aghevli, J. R. Dodsworth, J. C. Dunn, C. B. Mulder, M. B. Rose. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; S. G. B. Henry, G. R. Kincaid, D. C. McDonald, S. Oberg, E. J. Zervoudakis. European II Department: E. Brau, Deputy Director; M. J. Buchanan, I. Coelho, E. Gurgen, P. M. Keller, R. J. Robinson, M. Shadman-Valavi, P. van den Boogaerde, R. van Rooden, B. Weder. External Relations Department: H. P. Puentes. IMF Institute: M. W. Bell. Legal Department: F. P. Gianviti, General Counsel; R. H. Munzberg, Deputy General Counsel; H. Cissé, P. De Boeck, J. L. Hagan, R. B. Leckow, J. M. Ogoola, F. M. Zeidan. Policy Development and Review Department: T. Leddy, Deputy Director; F. C. Adams, A. Basu, N. L. Happe, R. T. Harmsen, A. Singh, E. van der Mensbrugghe, J. F. van Houten. Research Department: M. Mussa, Economic Counsellor and Director; M. Kumar. Secretary's Department: C. P. Clarke, A. Leipold, A. Mountford, S. L. Yeager. Southeast Asia and Pacific Department: K. Saito, Director, K. B. Bercuson, T. R. Rumbaugh. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; J. C. Corr, G. M. Fitzpatrick, H. Flinch, D. Gupta, C. A. Hatch, B. E. Keuppens, R. Thorne, T. L. W. Verheye, M. A. Wattleworth, B. C. Yuen. Office of the Managing Director: G. R. Saunders, Personal Assistant; J. G. Blanch. Advisors to Executive Directors: M. C. B. Arraes, G. M. Blome, P. Cailleteau, G. Y. Glazkov, J. Jonas, Y.-H. Lee, N. Mancebo, J. C. Martinez Oliva, M. F. Melhem, P. A. Merino, T. Oya, J. R. Suárez, N. Toé, A. Törnqvist, J. W. van der Kaaij. Assistants to Executive Directors: S. E. Al-Huseini, T. Berrihun, J. M. Burdiel, A. G. Cathcart, C. D. Cuong, M. Dzervite, G. Z. El-Masry, J. C. Estrella, S. S. Farid, M. Fein, L. Fontaine, C. Gaseltine, M. A. Hammoudi, S. Ishida, T. Kanada, A. M. Koulizade, T.-M. Kudiwu, G. J. Matthews, S. C. McDougall, J. A. K. Munthali, S. Narube, J. Pesola, C. F. Pillath, N. Prasad, M. W. Ryan, D. Saha, L. Tase, S. Vori, Wu H.

1. SOCIALIST FEDERAL REPUBLIC OF YUGOSLAVIA - MEMBERSHIP IN THE FUND OF SUCCESSOR STATES - EXTENSION OF PERIOD FOR FULFILLMENT OF REQUIREMENTS

The Executive Directors agreed to extend through December 14, 1994 the period for fulfillment of the requirements with respect to membership in the Fund of successor states of the Socialist Federal Republic of Yugoslavia.

The Executive Board took the following decision:

The period under paragraph 3(d) of Decision No. 10237-(92/150) of December 14, 1992 within which a successor may succeed to the membership of the Socialist Federal Republic of Yugoslavia in the Fund is further extended through December 14, 1994.

Decision No. 10700-(94/52), adopted
June 8, 1994

2. ZIMBABWE - REPORT BY STAFF

The staff representative from the African Department reported that a mission had visited Zimbabwe during May 10-26, 1994 to conduct discussions for the 1994 Article IV consultation and the review of the second-year program supported by parallel ESAF and extended arrangements. The mission had found that economic activity had picked up after the drought-induced recession and that the exchange reforms of January 1994 had so far proved successful, bringing about a virtual convergence of the market exchange rate with the official exchange rate. However, the mission had found also important deviations from program targets in the implementation of the Government's budget and in the area of public enterprise reform. The program ceilings on the budget deficit and the combined operating loss of public enterprises for end-March 1994 had been exceeded by the equivalent of 3 percent and 2 percent of GDP, respectively. In addition, the ceiling on short-term public external debt had been exceeded, and the structural performance criteria relating to civil service retrenchment and the maize pricing policy had not been observed. The authorities had indicated that the adverse results had been due to difficulties in controlling ministries' expenditure commitments, higher than expected domestic interest costs, and delays in the implementation of public enterprise reform.

The mission had discussed with the authorities possible corrective measures and had submitted an aide-mémore containing specific policy recommendations, the staff representative continued. The authorities had reaffirmed their commitment to the continued implementation of the program described in their letter of intent of January 12, and the accompanying staff report. In view of the slippages that had nevertheless occurred, the staff had advised the authorities that the original plan of presenting the staff report for the 1994 Article IV consultation together with the review of the program, could not be maintained. Instead, the staff proposed that the Article IV consultation should be concluded by the Executive Board as soon as the government budget for 1994/95 could be assessed and a few more months of performance under the existing program had passed. The staff expected to be in a position to conclude the consultation shortly after the Board recess. By that time, and after policies had been significantly strengthened, the staff would be prepared to resume discussions for the review of the program for consideration by the Executive Board sometime in November/December of 1994.

The Chairman observed that the delay represented an important disappointment for the Fund and, in light of the frequent requests by members of the Board to be informed immediately when such delays occurred, he had asked the staff to bring the matter to the attention of the Board. The situation was not so terrible that it could not be corrected. He took seriously the commitment of the authorities to put the program back on track, and he was certain that their commitment would be reiterated by Mr. Mwananshiku. Unfortunately, despite the good efforts and commitment of the authorities, the Fund was not in a position to conclude the review at the same time as the Article IV consultation.

Mr. Mwananshiku agreed that the authorities remained committed to the program and were prepared to take additional measures to ensure that the program was put back on track. Only the day before, they had taken a number of key measures: first, the two exchange rates had been merged; second, the authorities had agreed to the restructuring of ZISCO, the steel company, so that it could be privatized; third, they had agreed to the principle of privatizing all state enterprises and established a cabinet committee to ensure that that was done.

The authorities were in the process of preparing the budget for 1994/95 and they had agreed, in principle, that the deficit, excluding grants, would be about 4.5 percent, Mr. Mwananshiku continued; with the grants, obviously, the deficit would be much lower.

Mr. Dorrington welcomed the staff's report and the fact that the information had been brought to the attention of the whole Board in timely fashion. Particularly in view of the history of slippages and waivers in Zimbabwe, the strategy that the staff was proposing to follow was precisely right, and the matter should not be brought back to the Board until "policies have been significantly strengthened." He appreciated Mr. Mwananshiku's indication that there had been some actions taken by the authorities, but much of what Mr. Mwananshiku had mentioned was more program than actions; and in the past, the authorities had been stronger on promises than they had been on actions. He hoped that the next few months would show a different story.

3. VIETNAM - 1994 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION; AND PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered the staff report for the 1994 Article IV consultation with Vietnam, the review and modification of the stand-by arrangement approved October 6, 1993, and Vietnam's request for a second purchase under the systemic transformation facility (STF) in an amount equivalent to SDR 12.08 million (EBS/94/105, 5/20/94; Sup. 1, 6/3/94; and Sup. 2, 6/7/94). They also had before them a background paper on recent economic developments in Vietnam (SM/94/138, 6/3/94).

Mrs. Hetrakul made the following statement on behalf of Mr. Ismael:

In the period since the clearance of arrears to the Fund and the approval of the stand-by arrangement by the Executive Board, Vietnam has made significant progress in terms of its economic growth and domestic stabilization. Growth was higher while actual inflation was lower than targeted in the program. However, credit expansion could not be decelerated as quickly as planned, which resulted in a weakening in the external balance and led to non-observance of some of the performance criteria under the stand-by arrangement. The unfamiliarity of the authorities with the procedures of the Fund-supported program and lags in data availability, in particular in the monetary area, were in part responsible for these slippages. In addition, the policy response was slower than anticipated. However, the authorities have recognized the need to follow a significantly tighter policy stance than in 1993. Since the last quarter of 1993, they have been taking corrective measures; they have also committed themselves to stand ready to take additional measures, as necessary, to ensure that the overall objectives of the program are achieved.

On this basis, the authorities have requested the Board to grant waivers for nonobservance of some of the end-March 1994 performance criteria. At the same time, with the assistance of the staff, a revised program has been prepared in order to place stabilization policies back on track and continue with the structural reforms needed to develop a market economy.

The revised financial program for 1994 is designed to sustain a strong pace of economic growth, to enhance macroeconomic stability, and to rebuild international reserves. Fiscal and monetary policies will be strictly restrained, while structural reforms will continue.

The authorities are aiming to lower credit growth substantially through a transitional measure, while building an institutional framework to establish indirect instruments of monetary control. A system of quarterly bank-by-bank credit ceilings consistent with the target growth of overall credit has been introduced. The State Bank will strictly enforce these credit ceilings as well as impose appropriate penalties for noncompliance in order to bring credit expansion to a manageable level. The volume of refinancing is also to be reduced through higher refinancing rates to commercial banks and establishment of ceilings on the refinancing. In addition, reserve requirements for commercial banks will be fully enforced, and a buildup of excess reserves will be encouraged. At the same time, foreign-currency-denominated lending is being gradually phased out by the State Bank's abstention from such lending to commercial banks; the lending rate on foreign-currency-denominated loans from commercial banks has also been raised.

Regarding fiscal policy, the authorities plan to further reduce the budget deficit to a level that does not need financing from external commercial or domestic bank sources. They are aware that measures on revenue, as well as expenditure, need to be implemented. On the revenue side, the increase in tax rates on a broader base and higher fees and charges, coupled with a more efficient tax administration, should increase government receipts by over 1/2 of 1 percent of GDP. In this respect, the authorities are prepared to introduce additional measures by midyear if shortfalls occur. On the expenditure side, the authorities are committed to an identified budget-wide program to reduce wasteful capital and current expenditures. These revenue and expenditure measures are expected to reduce the budget deficit by 1 1/2 percent of GDP.

With regard to the mobilization of sufficient, appropriate financing, the authorities have taken actions in seeking possible rescheduling for commercial borrowing contracted in 1992-93, while trying to accelerate disbursement of pledges of official development assistance. If a substantial shortfall in financing remains, the authorities intend to implement additional revenue and expenditure measures, rather than to finance the shortfall through accumulation of external arrears or recourse to domestic bank financing. In this context, the authorities recognize the difficulties that can arise from commercial borrowing and affirm that they will refrain from contracting new external commercial borrowing of less than 12 years' maturity during the stand-by arrangement.

In regard to exchange rate policy, the authorities intend to allow the exchange rate to be primarily market determined. Intervention in the foreign exchange market will be limited to smoothing out short-term fluctuations and not opposing market trends.

Concerning the exchange system, it has been noted in the staff report (page 15, footnote 1) and the proposed decision that Vietnam maintains certain foreign exchange restrictions. In particular, the staff report mentions that "there is also an exchange restriction subject to approval under Article VIII, Section 2(a) arising under the bilateral payments agreement with Malaysia." The bilateral payments agreement issue was addressed in the Executive Board meeting on the 1993 Article IV consultation with Malaysia held on September 15, 1993. The position of this chair was, and continues to be, that as the agreements are of a voluntary nature, they do not constitute an exchange restriction. It was agreed at that time that the staff would prepare a paper on this issue to be submitted to the Board in order that a decision could be reached. Until that paper has been submitted and discussed by the Board, we feel strongly that no decision on this matter can be made.

In addition to the reforms in the monetary, fiscal, and external sectors as outlined, the authorities are at the same time developing a legal framework to strengthen the institutions necessary for an emerging market economy and overhauling the state enterprise sector. Several new laws were passed relating to land use, bankruptcy, economic courts, and the environment. Regarding enterprise reform, the authorities are committed to a further substantial reduction in public sector employment. Attention will be given to the relicensing of enterprises and the equitization of ownership, as well as compensation to unemployed workers and retraining schemes.

With the corrective policies implemented since the last quarter of 1993, the planned fiscal and monetary policies, and the structural reform measures on several fronts, Vietnam should be able to progress toward development of a market economy. Nevertheless, the firm policies under the program will need to be complemented by substantial continued support of the international community as well as the Fund's concessional financial assistance. The Executive Board's support of the proposed decisions on the systemic transformation facility and the stand-by arrangement will certainly facilitate the transformation process in Vietnam. Beyond this, Vietnam would like to move as quickly as possible toward an arrangement under the enhanced structural adjustment facility (ESAF).

In conclusion, I would like, on behalf of the Vietnamese authorities, to express their deep appreciation to the staff for its excellent work on the 1994 Article IV consultation and on the preparation of the economic and financial policies for Vietnam.

Mr. Sirat made the following statement:

When this Board discussed and approved a stand-by arrangement for Vietnam last October (EBM/93/141, 10/6/93), and in doing so brought to a successful end the long process of normalization of Vietnam's relations with the international financial community, several economic facts were apparent. On the one hand, growth was strong, exports were growing quickly, and inflation was on a steeply declining slope. On the other hand, demand pressures were putting a strain on external accounts, increasing the current account deficit, and pushing down external reserves.

This situation--high growth rather than depressed output--was in itself rather unusual and quite remarkable for an economy in transition; and the fact that domestic demand pressures translated into a worsening of the current account deficit rather than renewed inflation reflected an already significant degree of openness of the economy.

The macroeconomic policies under the program were designed to address this situation, and, as indicated in the report before us, some progress at cooling down the economy was indeed made in the last quarter of 1993 and in the first quarter of 1994. This can be seen, for instance, in the significantly slower pace of increase in domestic credit during this latter period than in the previous nine months.

Yet, due in part to inertia in modifying the earlier policy stance, this tightening was not sufficient and several performance criteria were missed. Thus, I welcome the additional measures that were taken by the authorities in the past months to tighten fiscal policy and to limit the expansion of domestic credit. This new set of prior actions, detailed in Attachment I to the memorandum of policies, represents significant and commendable efforts by the authorities to correct past slippages.

I note the staff's assessment that, with these measures, the performance criteria for June and September 1994 are attainable. I also observe that, under the revised program for 1994, the objectives for inflation and the overall fiscal deficit are at least as strong as under the original program and that it is projected that the 1993 deterioration in the external position should be substantially reversed. Consequently, with the program thus back on track, I fully support the proposed decisions on the review and modification of the stand-by arrangement and on the purchase under the STF.

Let me add a comment on one specific corrective measure taken, namely, the imposition of credit ceilings on a bank-by-bank basis. I understand that some have little appetite for this kind of measure in any circumstance and emphasize the distortions in credit allocation it may induce. I, for one, would argue that, in view of the urgent need to control credit and of the weaknesses of both banks--loaded as they are with assets of dubious value--and the supervision system, this measure is the best pragmatic response in the current circumstances. And it is likely to remain that way as long as the health of the financial system and the supervisory powers of the central bank do not significantly improve. I prefer running the risk of incurring the cost of some distortion in the allocation of credit rather than face the alternative of runaway credit and the much more significant cost of an inevitable macroeconomic clampdown.

Turning to the medium term, the report makes clear--and it is no surprise--that there is in Vietnam a long agenda of desirable structural reforms. High on the list of priorities is the establishment of a comprehensive legal framework for private sector activities, including foreign investment. In view of the fragility of the external accounts and the potential for foreign investment, this could indeed have a highly beneficial effect. Some action has been taken in this regard, but more is certainly needed.

Many other valuable structural reforms could be mentioned, for example, as mentioned in the staff report, broad modifications of the tax system and a comprehensive overhaul of the financial sector.

The breadth of the agenda of reforms highlights the need for continued determination on the part of the Vietnamese authorities in their restructuring efforts, but also, and just as important, for continued financial support by the international financial community.

In this respect, the high level of support that has been committed so far is heartening: bilateral and multilateral creditors, including my own country, pledged substantial amounts of aid to Vietnam at the Aid Group meeting that was held last November in Paris; and Paris Club members provided debt rescheduling on generous terms.

I understand that the challenge now is to ensure a full, efficient, and rapid disbursement of the funds that have been pledged. It is a challenge for the authorities. In this respect, I welcome the indication that steps are under way to remove internal obstacles to aid disbursements, and I hope that these steps will significantly reduce the existing bureaucratic obstacles and delays. It is as well a challenge for the creditors, particularly so in view of the size of their commitments, and for the multilateral development banks. While maintaining an adequate level of conditionality, they must be ready to be flexible and pragmatic in their program design to ensure timely disbursements of their lending.

As regards the Fund, its efficient response last October has been instrumental in helping to catalyze the aid flows just mentioned. But this stand-by arrangement is only a first step. An enhanced structural adjustment arrangement remains indispensable. I understand that the staff and the authorities are to resume promptly discussions on a program that could be supported by ESAF resources, and I very much welcome this. I would appreciate additional information on the timetable that is envisaged for this arrangement under the ESAF.

Mr. Kannan made the following statement:

We are impressed to note that Vietnam has registered a growth rate of 8 percent in 1993, following a remarkable growth rate of 8.3 percent in 1992. Furthermore, containment of inflation at 5.2 percent in 1993, as against 17.5 percent in 1992, is no doubt an encouraging sign. While these indications clearly point to a healthy improvement, the authorities have to intensify their actions in the monetary, fiscal, and external areas in order to consolidate the gains of their earlier efforts. In this context, the following points deserve our attention.

In the monetary sector, authorities must strengthen banking supervision, and hence the payments system, and further develop the capital market. In the banking system, the central bank relies mainly on interest rates, reserve requirements, and quarterly bank-by-bank credit ceilings for monetary control. But reserve requirements are not enforced uniformly and effectively. Attempts must be made to improve this before introducing other measures of banking sector reform. The system of quarterly bank-by-bank credit ceilings may be continued temporarily for some time. The interest rate structure must be simplified and must reflect market conditions with the main objective of boosting national savings. While we welcome the decision to introduce bills on an auction basis, the authorities should not be hasty in the introduction of indirect methods of monetary control. Carefully planned sequencing of financial sector reform is called for. Perhaps the staff could comment on whether the subsidization of interest rates is being maintained and, if so, whether the authorities have any plans to phase it out. Furthermore, could the staff throw some light on the level of credit extended by nonbank financial institutions.

Although the overall fiscal deficit is projected to decline to 4.5 percent of GDP in 1994 from 6 percent in 1993, no abatement in expenditure is seen. In the past two years, wages accounted for a considerable share, and this item continued to account for a substantial increase in total expenditure. While the authorities may expedite the implementation of all expenditure restraint measures, we do not see any commitment to containing wages in the near future. The staff may wish to comment.

We welcome the steps taken by the authorities to replace import quotas with tariffs. With liberalization of this nature, there is every possibility for imports to grow faster, at least in the immediate future. Under this scenario, it is not clear how import growth could be contained at about 10 percent in 1994/95 as against about 30 percent in 1992/93. Attempts must be made to do so; otherwise, this will have a deleterious effect on the current account balance.

Furthermore, as credit to the nongovernment sector is also targeted to slow down, it is not clear how the economy could still improve its investment--as a percent of GDP--at about 15 percent in 1994/95 as against about 13 percent in 1992/93. Hence the possibility of reducing the current account deficit to about 5.5 percent of GDP seems very weak. Under such circumstances, the exchange rate has to play a predominant role. The relative stability of the dong in the recent period, in spite of a huge increase in the current account deficit, reflects strong official intervention. We encourage the authorities in their commitment to the implementation of a market-determined exchange rate regime. To this end, and bearing in mind the need to rebuild reserves, the authorities may not undertake concerted action to support the dong; more generally, official intervention in the foreign exchange market should be limited to smoothing out short-term fluctuations. Could the staff provide any figures on official intervention, as this is having a strong impact on net international reserves. Furthermore, could the staff comment on whether there is an urgent need to modify the exchange rate system in Vietnam.

Although Vietnam could negotiate a slightly higher external loan, compared with the Fund-supported program, we noticed a substantial deviation with respect to maturity. Does the change in maturity pattern warrant any revision in the current account position and hence on the debt-servicing capacity? The staff may wish to comment.

The staff report clearly mentions that the performance criteria originally established under the stand-by arrangement relating to net domestic assets of the banking system, net bank credit to the Government, net international reserves, and contracting of external debt were not observed for end-March 1994. With the huge increase in net domestic assets of the banking system and with an increase in the inflation rate--by about

5 percent--during the first four months of 1994, we are concerned whether the performance criteria for 1994 could be observed. We could not understand the rationale of the statement by the staff that "the program projection of a 7 percent inflation rate for 1994 is thus still regarded as attainable" (EBS/94/105, Sup. 1).

Vietnam has been given technical assistance in one area or another since May 1990. However, the statement by Mrs. Hetrakul that "the unfamiliarity of the authorities with the procedures of the Fund-supported program and lags in data availability, in particular in the monetary area, were in part responsible for these slippages," underlines the need for better and fuller utilization of technical assistance in future.

We are all aware that the adjustment process is a medium-term concept in which the willingness of the authorities to introduce necessary policy ingredients is the most important step. As this is clearly established in Vietnam, we endorse the proposed decisions.

Mr. Fukuyama made the following statement:

I commend the staff for its strenuous efforts in encouraging the Vietnamese authorities to persevere with economic reform and to take the necessary corrective measures to get the program back on track.

It is regrettable that most of the performance criteria for end-December 1993 and end-March 1994 were not observed. However, it should be noted that the authorities have implemented many corrective measures in line with the staff's advice which have resulted in an improvement in economic performance.

In light of the strength of the authorities' commitment to economic reform, I have no difficulty in supporting the proposed decision.

Before commenting on specific economic measures, I would like to make a general comment on the authorities' basic stance on cooperating with donors.

Vietnam returned to the international financial community last October after clearing its arrears to the Fund, and it is now in the process of normalizing its relations with its external creditors, which is expected to lead to a rescheduling of its loans. During this process, I understand that there has been some friction between the Vietnamese authorities and creditors, including both Paris Club creditors and commercial banks, which has resulted in a delay in concluding the negotiations. Although it is not easy to identify the cause of the friction, it seems to be mainly due to the authorities' obstinacy in maintaining their stance of trying to maximize their own benefits, as well as to their lack of expertise in debt negotiations. I am concerned that this friction might affect the momentum of donor community assistance to Vietnam. I would remind the authorities of the vigorous and cooperative efforts of bilateral and multilateral donors and the staff to help clear Vietnam's arrears to the Fund. It took them almost two months to conclude the lengthy discussions on the details of a possible operation for the clearance of arrears, which included a complicated bridge loan.

Vietnam's future will depend crucially upon positive support from the international financial community, and it is extremely important to maintain the momentum of donors' assistance. I hope the authorities will keep this in mind and take a more reasonable stance in the negotiations with donors.

Let me now turn to some specific policy issues. I am, in particular, concerned about the slow progress in structural reform. I would emphasize that immediate priority should be given to those measures necessary to facilitate foreign capital inflows, which are essential in order to enable a smooth transition to sustainable growth in the medium term. More specifically, the authorities should accelerate trade liberalization and the overhaul of state enterprises. With regard to the latter, Vietnam has lagged behind the states of the former Soviet Union. I urge the authorities to establish an ambitious and comprehensive plan for the state enterprises with a concrete timetable and to implement it as planned.

Vietnam has another challenge--that of moving to an ESAF arrangement, which will contribute greatly to the improvement of its external position in terms of a low interest rate and access amounts. I would like to emphasize that full implementation of the revised program supported by the stand-by arrangement is an important prerequisite for Vietnam to qualify for an ESAF arrangement.

Mr. Waterman made the following statement:

From an overall perspective, Vietnam has made good progress in recent years. GDP has grown strongly and inflation has trended downward. If anything, Vietnam is currently trying to overcome the problems associated with pressure to do "too much too quickly." That is reflected in some of the difficulties that have arisen in respect of the stand-by arrangement.

It can be argued that the authorities should have addressed these issues earlier and thereby avoided the need to seek the waivers that are now required. The recent corrective measures taken and planned are, nevertheless, to be welcomed. If fully implemented, they could provide a solid basis for sustainable growth and continued economic reform over the coming years.

At the heart of Vietnam's problems over the past year has been expansionary monetary growth. That this has not been reflected in higher inflation, but rather in stronger import growth, is remarkable in itself. Perhaps the staff would like to comment on the reasons for this. The authorities may have promoted private sector credit growth in some minor ways, but the key to the problem appears to have been that the authorities lacked the mechanisms through which they could control credit growth. Where they had such a mechanism, that is, in the area of state-owned enterprises, credit was restrained. Where they did not, in the private sector, credit growth skyrocketed. I agree with the staff and Mr. Sirat that direct credit controls will be an important, if temporary, mechanism by which private sector credit growth can be restrained over the coming months. Indeed, it was cases such as this that I had in mind during the work program discussion when I mentioned that the proposed paper on the transition from direct to indirect monetary policy operations could usefully look at those countries that had found it desirable to maintain direct controls.

Developments on the budgetary front during 1993 underline that a country in Vietnam's position needs to have a weather eye on both the size of the deficit--which came in broadly as expected--and the financing of that deficit. In particular, the authorities took the unfortunate step of relying on short-term commercial borrowing for budgetary financing. We agree with the staff that such borrowing seems inconsistent with the needs and financing capacity of Vietnam and should therefore be avoided wherever possible. The part of the deficit that was monetized contributed to the problems arising from excessive monetary growth.

The implementation of measures, on both the taxation and expenditure fronts, to limit the size of the deficit for 1994 are, therefore, welcome. We are also encouraged by the authorities' commitment to avoid new external commercial borrowing and to eliminate monetization of the deficit.

At the heart of the fiscal policy challenge in Vietnam is the need to strike the right balance between the size of the overall budget deficit and the amount of external concessional financing available. The November 1993 Aid Group meeting produced some positive results in terms of the amounts pledged, but to date, disbursement of that financial assistance appears to have been quite disappointing. Of course, it would be possible to reduce capital expenditures to match lower disbursements, but substantial cutbacks would put at risk what has been one of the great strengths of economic reform in Vietnam--solid economic growth. We would therefore join Mr. Sirat in encouraging all donors, including the multilateral development banks, to ensure that all disbursements are made on a timely basis to enable improved budgetary management by the Vietnamese authorities. For its part, Vietnam needs to be alert to the possibility that flows may not always turn out to be quite as intended and that some contingency measures that improve budgetary flexibility are required.

I am not familiar with the problems that Mr. Fukuyama has just referred to with regard to creditors and donors, but on the face of it, it seems the Vietnamese authorities can assist in improving relations on those fronts.

The authorities have made good progress in some areas of structural reform. I agree with the staff's views in this area, particularly on trade and exchange rate arrangements, so I will not go over those policies. I will merely add that those measures will need to be built on, I hope in the context of an ESAF-supported program, which, providing the authorities fully implement their commitments under the revised stand-by arrangement, could usefully follow this current program.

Finally, I can support the proposed decisions.

Mr. Zhang made the following statement:

As in previous years, Vietnam's economic performance in 1993 and early 1994 was impressive. Economic activity was strong and inflation low. The external position remained viable. Notwithstanding these positive developments, several performance criteria under the stand-by arrangement were not observed. Having recognized this, the Vietnamese authorities, in close consultation with the staff, revised their economic program. We believe that the amended program is more realistic and attainable. Therefore, we endorse the request for waivers of the nonobserved criteria and support the proposed decisions.

With supportive fiscal and monetary policies, domestic economic activity in the first part of 1993 was buoyant. Such robust domestic absorption was supported mainly by the large volume of imports. International reserves, in turn, declined sharply. As evidence showed that such movements would not be sustainable, the authorities adopted a restrictive financial policy in the last quarter of 1993. According to the staff supplement, in the first quarter of 1994 there was a deceleration in domestic credit expansion and a moderate rebuilding of international reserves.

We share the staff's concern, however, that continued excessive credit to the nonstate sector should be further reduced. It will help to ensure observance of performance criteria and, more important, will make the economy grow in accordance with available resources. As the market-based mechanism for monetary control still needs nurturing, credit ceilings remain effective credit policy tools. But immediate efforts should be made to speed up financial sector reform, so as to develop interbank and government securities markets, as well as to make commercial banks more accountable. These reforms are vital for the effective transfer from direct to indirect monetary control and need time to be implemented. I wonder whether the authorities have discussed any timetable with the staff regarding such a financial sector reform package.

In addition, we are concerned that during March 1994 there was a substantial expansion in other net items in the monetary survey. Such unexplained movements reinforce the need to improve Vietnam's weak statistical system. I wonder whether the large volume of floats, resulting from the underdeveloped payments system, has contributed to the changes in other items. The staff's comments will be welcome.

Fiscal development is a source of concern. Although the latest fiscal data indicate that revenue and current expenditure are in line with program projections, significant shortfalls in foreign concessional assistance and domestic nonbank borrowing will require further cuts in capital spending or other fiscal action to achieve the programmed overall deficit target.

We believe that room should be found to streamline further current expenditure rather than reduce capital expenditure. Rapid economic growth requires significant improvement in the energy, transportation, and telecommunications areas. Huge investments will be needed in the coming years and even decades. Otherwise, increasing bottlenecks in these and other areas will impede sustainable economic growth and long-term economic development. Government capital expenditure will continue to play an important role in this process. Further cuts in capital spending can only exacerbate the difficulties. With this in mind, we encourage the authorities and the staff to overhaul the expenditure structure to achieve the overall budget target without sacrificing the much-needed capital expenditure.

As for the financing issue, we hope that external creditors will be able to provide timely concessional assistance, which is of vital importance to the transformation process in Vietnam, as stated by Mrs. Hetrakul. In this connection, we welcome the authorities' intention to move as quickly as possible toward an ESAF arrangement. In addition, the Vietnamese authorities should reduce their reliance on external commercial lending. Moreover, any larger than expected overall deficit resulting from continued shortfalls of external financing should not cause corresponding increases in monetary financing. Efforts should be made to seek an increasing role for nonbank financing of the deficit.

It goes without saying that external viability in Vietnam is associated with the phased liberalization of trade and exchange regimes. However, more remains to be done. Multiple currency practices and a restrictive trade regime are not in Vietnam's long-term interests. Hence, we encourage the authorities to make the trade and exchange regimes more transparent.

Ms. Kouprianova made the following statement:

Vietnam has made substantial progress over the past few years in achieving economic transformation and shifting from a centrally planned to a more open and market-oriented economy. Rapid growth has been reached in the past year, based on reduced inflation and other successes in several key areas of Vietnam's economy. But there is still room for improvement in all areas of economic functioning. The performance under the stand-by arrangement was mixed, and there have been serious slippages in the program. The performance criteria relating to net domestic assets of the banking system, net bank credit to the Government, net international reserves, and the contracting of external debt were not observed. I fully share the staff's concerns about this mixed performance as expressed in the report on Vietnam's present situation, and I welcome the corrective measures that the authorities have taken to date to put the program back on track. As I support the objectives of the revised program for 1994, I will limit my intervention to four general remarks and one specific remark.

First, on monetary developments in Vietnam, although important progress has been made in reducing inflation by almost 12 percent, instead of the planned 5.5 percent, in 1993, controlling credit expansion remains one of the most important policy issues. Credit to the private sector has expanded almost twice as much as the program target of 89 percent for 1993 and remains excessive. This situation was worsened by the reduction of effective lending rates, the fall of reserve/deposit ratios, and the high level of liquidity expansion during March 1994. The authorities took action, and we welcome the first steps on the road to improving the monetary situation: retiring some commercial borrowing from the State Bank, limiting foreign currency holdings, raising maximum lending rates, and introducing bank-by-bank credit ceilings. The introduction of indirect monetary instruments, however, seems premature in the present situation. Introducing these instruments requires comprehensive reform of the financial sector by developing the reserve requirements system, improving banking supervision, and restructuring state-owned banks. This important issue needs additional consideration.

Second, although the fiscal outcome for 1993 was broadly in line with the program, additional fiscal measures clearly need to be taken to reduce the 6.5 percent deficit. On the revenue side, performance has been good. Several successful measures, such as import revenue increases and tax collection expansion, have been taken, and, as a result, the revenue/GDP ratio has risen by 4 percentage points from the 1992 level. On the expenditure side, the ongoing large public sector spending increases--namely, the rise in current expenditure by 5 percent to 23.5 percent of GDP in 1993--are still a matter of concern. Capital expenditure has also increased by 1.5 percent to 7.7 percent of GDP. I would urge the authorities to maintain strict control over both current and capital expenditures, and I share the staff's point of view that greater emphasis on expenditure reduction, rather than on revenue collection, is needed.

Third, Vietnam's external current account deficit has risen to 9 percent of GDP, which is 2.5 percent more than envisioned under the program. Gross official reserves have also fallen below target by 3.5 weeks of imports. We welcome the intention of the authorities to limit interventions in support of the dong, remove the exchange restrictions on current international transactions, and remove obstacles to international trade and multiple currency practices. I fully share the staff's point on the need to follow prudent external debt policies and strictly control the amount of commercial borrowing. Keeping in mind that external financing on nonconcessional terms should be kept to an absolute minimum, the Government's intention to borrow $100 million on commercial terms, which are currently being negotiated, is questionable.

Fourth, although progress has been made in structural reform, it is not sufficient. Structural reform efforts should be doubled to create the basis for macroeconomic stabilization and adjustment. First, priority should be accorded to trade policy; we encourage the authorities to speed up the process of modifying procedures for issuing import permits and to reform the tariff structure to stimulate private sector participation in foreign trade. The second important issue is reform of the public sector and privatization. Progress has been made in the restructuring of state enterprises, but we would certainly welcome additional steps here. A high percentage of consolidated state-owned enterprises are still loss-making, and the liquidation process is slow. The second phase of the privatization program has met with strong opposition and is also proceeding slowly. A doubling of the efforts in this important area of structural policy is clearly needed. The third key area of structural reform is the development and adoption of a market-oriented legal framework as a necessary condition for overall macroeconomic improvement.

Let me now make a specific remark on external debt. Normalizing relations with external creditors is still an important issue. Despite intergovernmental agreements, and despite the fact that currently the Vietnamese authorities are having ongoing discussions with bilateral creditors, Vietnam has been slow in eliminating and rescheduling its debt with the Russian Federation. We strongly urge the authorities to normalize relations with all creditors and to reach an understanding on eliminating the arrears no later than September 1994.

To conclude, I am confident that the Vietnamese authorities will be able to improve their policies in the fiscal, monetary, structural, and external areas to pave the way for a successful economic transformation over the medium term. We are encouraged by the Government's readiness to take additional measures to achieve the objectives of the program. We support the proposed decisions.

Ms. Lissakers made the following statement:

It is unfortunate that Vietnam's growth ambitions, already evident when the program was approved last October, drove this program off track so quickly thereafter. Growth was strong, inflation came in a little better than expected in 1993, and efforts to rein in an apparent fiscal expansion were largely successful. But the authorities succumbed to other temptations, including unwarranted short-term commercial borrowing and exchange market intervention. Lax monetary oversight complicated an expansion of credit to the private sector already under way. As a result, numerous performance criteria were missed, Vietnam lost a sizable chunk of its reserves, and the current account deficit exploded, compared with that in 1992.

Fortunately, Vietnam seems to have made a credible effort to get this program back on track. We share the staff's appraisal of Vietnam's efforts so far, and of the weak spots that remain in the transition to a market economy. However, we remain concerned about several aspects of the 1994 program, including the implications of recent fiscal and monetary developments noted in the supplementary report, exchange rate policy, and commercial borrowing intentions.

The apparent tightening of fiscal and monetary policies over the past few months is welcome. But we are concerned that monetary policy still may be out of line with the revised program and that some lingering data problems are obscuring possible problems.

Action may be needed to ensure that yet another round of targets is not missed. On the fiscal side, we understand the difficulties that stem from slower than expected disbursements of external assistance, but we agree with the staff that the overall deficit target should be preserved, through expenditure cuts, if necessary.

What should not be repeated is the recourse to short-term commercial borrowing that Vietnam utilized last year to support the budget. Given the still delicate financial situation and ample access to concessional assistance and financing, we do not see a compelling rationale for the $100 million in short-term borrowing permitted, and apparently contemplated, under the 1994 performance criteria. The program approved in October 1993 had specified that there would be no such borrowing in either the 1-12 or 1-5 year maturity ranges under the stand-by arrangement in 1993 and 1994. If anything, the fact that Vietnam appears to have encountered nearly immediate difficulties servicing the short-term suppliers' credits that it contracted in 1992-93, and is now seeking a rescheduling, should inject a strong note of caution. For now, we think the authorities should resist the temptation of public or publicly guaranteed commercial borrowing. Instead, the active efforts now under way to speed disbursements of external assistance, in combination with a much more ambitious program to clear away permanently the many unnecessary regulatory hurdles to foreign direct investment, could help ensure that Vietnam's external financing needs are met.

As to exchange rate policy, we welcome the commitment to turn away from sustained exchange market intervention in support of the dong, as well as Mrs. Hetrakul's assurances that intervention will not be used to oppose market trends. Currency stability should be achieved through tight adherence to the monetary and fiscal elements of the program, not by jeopardizing official reserves and export competitiveness. Of course, a hands-off approach by the State Bank should be accomplished by more rapid progress toward a functioning foreign exchange interbank system to further increase the role of market forces in determining the exchange rate.

Vietnam has made progress on the limited, though important, set of structural issues set out in the stand-by arrangement. But the structural reform effort needs to be extended and strengthened should Vietnam be in a position to utilize resources under an ESAF arrangement later this year. Three areas deserve immediate attention: financial sector reform, private sector development, and the trade and exchange regime.

Financial sector reform is required to improve the State Bank's ability to conduct monetary policy and to establish an efficient market-based financial infrastructure that will emphasize the role of private institutions. Work to improve the legal framework and deal with the problems at the state banks should be an early priority to cope with problems in the banking sector; the plans Vietnam is formulating in conjunction with the World Bank and the Fund are welcome in this regard.

The scope for private sector activities needs to be widened as far as possible through further restructuring and privatization of state-owned enterprises and through elimination of the present list of products and services reserved for the state sector. Broad deregulation would help spur both domestic and foreign investment.

Finally in this connection, the numerous trade restrictions that Vietnam still maintains, especially on the import side, must be lifted and, as I noted earlier, the exchange rate system reformed to eliminate the practices that distort the pricing and allocation of foreign exchange.

I have said little about fiscal policy, which seems to be moving in the right direction. The overall outcome in 1993 fell just shy of projections, revenues are up considerably, and expenditures have been restrained. I, therefore, have just two comments in this area. First, we noted in October 1993 that a real reduction in defense expenditures merits serious consideration. Instead, we see that this is the fastest rising category of the budget, up 31 percent in 1994, and itself amounts to more than 7 percent of GDP. This level of unproductive expenditure seems inconsistent for a country with pressing social and public investment needs, and we would repeat our past advice, especially if additional expenditure cuts become necessary to ensure that the program stays on track. Second, the lack of transparency of the "other" expenditures category in the budget points to a need for more transparent and detailed budgetary data. Efforts in this direction should be completed prior to the end of 1994 so that they can go into effect with the 1995 fiscal year budget that takes effect on January 1.

In the interest of ensuring that other transition economies have the benefit of Vietnam's experience, and in light of the general level of public interest in Vietnam, I would suggest that at least the background paper on recent economic developments be published.

Finally, the United States wishes to be recorded as abstaining on the decisions relating to Vietnam's request for a purchase under the stand-by arrangement, and for a purchase under the STF.

Mr. Shaalan made the following statement:

I am in broad agreement with the staff appraisal, and I support the proposed decisions, as outlined in the staff report. I would like to briefly highlight Vietnam's remarkable economic performance, before commenting on two issues, namely, private sector credit and foreign debt.

First, we commend the Vietnamese authorities for the remarkably smooth transition they are pursuing from a centrally planned economy to a more market-oriented one. Unlike most transition countries in Eastern Europe and the former Soviet Union, Vietnam has been transforming its economy with a robust annual GDP growth of 8 percent, supported by a buoyant expansion of exports and a significant decline in the rate of inflation. Most impressive has been Vietnam's success in liberalizing its economy and adjusting to the collapse of trade with its former trading partners in the Council of Mutual Economic Assistance. Over the past four years, non-oil exports have soared at annual rates of 16 percent and more, and almost all of Vietnam's foreign trade is now conducted in convertible currency with industrial countries and other neighboring Asian economies. Having said that, there is yet much to be done, particularly financial sector reform and other structural reforms referred to by other speakers.

Second, the rapid credit expansion to the private sector could cause overheating of the economy and thus a return to higher inflation. The nonobservance of the performance criterion on net domestic assets is mainly a reflection of the excess in private sector credit. This slippage highlights two areas of weakness that need to be addressed. The first is the lack and/or the poor quality of statistical data in Vietnam. As detailed in Annex IV of the staff report, the Fund, in close cooperation with the UNDP, is the leading provider of technical assistance to Vietnam. We strongly support the Fund's role in this field, which, in time, will help to alleviate this problem. The second area of weakness is closely related to the first and is in the field of monetary policy. Given the lack of adequate indirect instruments of monetary control, the authorities in April 1994 introduced bank-by-bank credit ceilings to limit private sector credit expansion. While we can go along with this direct intervention as a second-best solution, we hope that it will give way to reliance on indirect instruments as soon as feasible.

Third and finally, we are concerned about Vietnam's resort to considerable external borrowing at commercial rates. In view of its rather short maturity, improving the maturity structure would enhance the country's foreign debt profile. In this connection, I note that most of the official development assistance pledged in late 1993 to Vietnam was project related, and disbursement delays have been experienced. The question that arises is whether the authorities contracted the commercial credits as bridging loans, and whether it is their intention to repay these loans using official development assistance, once disbursements are realized. Some clarification by the staff on this issue would be appreciated. Concessional financing is critical to the program's success, and we, therefore, welcome the authorities' intention, as stated by Mrs. Hetrakul, to move as quickly as possible toward an ESAF arrangement.

The staff representative from the Central Asia Department observed that Executive Directors' remarks reflected the critical nature of the present stage in Vietnam's relationship with the Fund. As Mr. Sirat had mentioned, an ESAF arrangement could be considered in future, but Vietnam would first have to show a proven track record of stabilization efforts. Results of the measures adopted by Vietnam to achieve the program targets for 1994 were not yet evident, and in terms of a timetable for an ESAF arrangement, meeting the end-June performance criteria--on which information would be available only toward the end of August--would be crucial. Meanwhile, the staff would look at other essential factors for an ESAF arrangement and that reflected the authorities' commitment to structural reforms.

In that context, the questions raised by a number of speakers about the attainability of the present program objectives were valid, the staff representative continued. Large policy slippages had occurred in the previous year, partly because of adverse circumstances, but also because of the authorities' lack of total commitment.

Inflation had surged to 5 percent in the first four months of 1994, while the target for the year as a whole was 7 percent, the staff representative pointed out. The authorities would have to repeat the inflation performance of 1993 in order to meet the program target, but the manner in which they moderated inflation would have to be very different. In 1993, high credit expansion had led to an outflow of reserves, a sharp rise in imports, a large increase in consumption, and a fall in national savings. Although the authorities had met the 1993 inflation target, the staff would not want to see the 1994 inflation target met in a similar manner.

Given that 1993 had seen a high level of consumption in Vietnam, the program investment target of about 2 percentage points of GDP was attainable, particularly if aid disbursements accelerated, as expected under the program, the staff representative commented.

With regard to monetary data, a few speakers had commented on the expansion in other net items, the staff representative recalled. The staff did not have detailed information on the expansion, but it was probably related to government expenditures, owing to both a lack of nonbank domestic financing of the Government and the slowness of aid disbursements. The staff hoped that both situations would be rectified in the following quarter and that program targets would be met.

A number of speakers had stated that a change in exchange rate policy was necessary, the staff representative noted. The report stated clearly the staff's support for a market-based exchange rate policy. The inappropriate intervention of the authorities in trading flows in 1993--amounting to about $120 million in net sales in Hanoi and Ho Chi Minh City--had constituted a serious deviation from the program, at a time of net outflows of reserves. Official data for the current year were not available, but he believed that further net sales had occurred, and the matter would be taken up in forthcoming discussions with the Vietnamese authorities. Although some stabilization, or even small increase, of reserves had occurred in the first quarter of 1994, the staff believed that a more market-determined exchange rate policy should be followed; in that respect, the main step would be for the Vietnamese authorities to move to an interbank foreign exchange market to determine the exchange rate and make it more difficult for the State Bank to intervene.

As to fiscal policy, the budget was not very transparent, the staff representative remarked. Ms. Lissakers had mentioned the sharp increase in military expenditure in 1994; that rise was largely due to wage reform, but the staff would endeavor to obtain more detailed information, particularly with respect to the large "other" category. The actual figures for military expenditure--at about 2.5 percent of GDP, or an increase of 31 percent--might not be comprehensive. More generally, it would be necessary to take additional fiscal measures if aid flows did not materialize as quickly as expected. Problems had arisen in 1993 owing to inflexible fiscal management: despite lower resources, the authorities had moved ahead with expenditures and commercial borrowing and in doing so, had changed the maturity structure of debt service significantly. Short-term suppliers' credits contracted to finance a north-south electricity line had alone added about 1 1/4 percent of GDP in debt service due in 1994. The staff had advised the authorities to exercise greater caution; the only way to improve the situation was through debt-service rescheduling, and the authorities were discussing that option with the supplier companies. The commercial loans involved were bridging in the sense that the authorities considered that urgent projects could not wait for disbursement of official development assistance. When available, that assistance, particularly quick-disbursing program loans, might well be used to repay the commercial loans. Nevertheless, that policy was not advocated by the staff.

On the timetable for structural reforms, the staff had discussed a draft policy framework paper, notably with respect to financial sector reforms that were particularly important and relevant to the discussions on direct versus indirect instruments, the staff representative remarked. A treasury bill auction system should be introduced as soon as possible, as one of the prior actions in connection with an ESAF arrangement. Similarly, concessional refinancing, reduced to 95 percent of the applicable rate for most institutions, should be completely eliminated prior to an ESAF arrangement. Although some exception might be made for agricultural credit, in general there was no reason for subsidies to interest rates.

The staff mission in March 1994 had used the World Economic Outlook's January commodity price forecasts for crude oil of $13.75 a barrel, the staff representative from the Central Asia Department reported. The present price of $16.22 a barrel would not affect the balance of trade significantly, because Vietnam did not have any refining capacity and exported all its crude oil, while it had to import all its needs.

Ms. Lissakers observed that recently a few programs before the Board had included oil price assumptions that later proved to be drastically understated. Given the importance of that commodity in most countries' balance of payments, the programs for Board consideration should include a more up-to-date assessment of oil prices for the coming year.

The Deputy Director of the Policy Development and Review Department explained that the projections used under various programs were updated regularly on the basis of the latest World Economic Outlook estimates. Perhaps the question to be addressed was how long after a program was negotiated could prices be updated, thus changing the structure of the program. He would note that the World Economic Outlook forecast of January--$13.75 a barrel--had been used as a basis for the program; in April, the projection had remained largely unchanged at $13.80 a barrel.

The Chairman encouraged the staff to achieve more transparency and comprehensiveness in the budgetary data, particularly with respect to military expenditures.

Mr. Waterman commented that Directors were supportive of Vietnam's economic reform program, but it was at a critical stage; there had been significant slippages in respect of some objectives. It was very important that the Vietnamese authorities get the program back on track. Many Directors would like to see Vietnam graduate to an ESAF-supported program, but that step was not a foregone conclusion, and further progress by the Vietnamese Government was necessary.

The staff's comments on fiscal management were particularly appropriate, Mr. Waterman continued. The authorities should exercise flexibility in that area. Although ideally governments and institutions should meet their committed aid disbursements on a timely basis, the Vietnamese authorities would have to react to the situation as it was; in case of a shortfall, they would have to take appropriate contingency fiscal measures.

Ms. Srejber made the following statement:

> First, like other Directors, I wish to commend the Vietnamese authorities for the progress they have made in stabilizing the economy while maintaining strong economic growth.

At the same time, there have been serious policy slippages and delays of important reforms.

In her statement, Mrs. Hetrakul explains these shortcomings partly by the unfamiliarity of the authorities with the procedures of a Fund-supported program and the lack of data. This may be true, but from reading the staff report I believe it is obvious that another, more fundamental factor has played an important role, namely, weak institutions and weak administrative capacity. If the new program is to succeed, it is thus of paramount importance that the administrative capacity be strengthened, outdated procedures modernized, and the necessary institutional and legal framework put in place. We would have liked to see more focus on this in the program by including some central reform measures in the performance criteria

This problem seems to be present in several areas. Like many other speakers, I would like to focus on one area of crucial importance for the development of a market economy: the financial sector. Even if there has been considerable progress, it is not clear whether one can consider a two-tier banking system fully established in view of the extensive refinancing activities of the State Bank. Furthermore, and perhaps more serious, the health of the commercial banks seems to be unclear. Proper supervision and auditing, as well as modern bookkeeping, of the banks are not yet in place, and full information about the extent of nonperforming loans is not available. Improvement in this area is urgent, as banking problems could endanger economic growth by shaking confidence and undermining government finances. The necessary legal framework has to a great extent been put in place, but there seem to be problems of implementation. All this points to the need for strengthening the capacity of the central bank, not only in policy implementation, but also in the statistical and supervisory areas.

Also in the fiscal area, the need for improved administrative capacity is evident, not least from the delays in tax reforms. I urge the authorities to go ahead with the reforms proposed by the staff in order to increase allocative efficiency and broaden the tax base. I welcome the technical assistance that is under way in this field.

Finally, on external policies, to stop the deterioration of the external balance is an essential element of the program. This requires a substantial improvement of the export performance. Against this background, one would have expected a more comprehensive discussion of exchange rate policy in the report. It is not clear what principles or motives this policy is based on, or indeed what the policy is. According to the report, the authorities have indicated that they will refrain from foreign exchange interventions other than smoothing operations, in line with the staff's advice. Mrs. Hetrakul goes a bit further, saying that this is what the authorities intend to do. We would have preferred a stronger commitment in this respect.

Mrs. Wagenhoefer made the following statement:

The Vietnamese authorities are to be commended for the strong GDP growth rate since 1992, which was achieved without fueling inflation. We welcome the information that strong growth is expected to continue for the coming years. Nevertheless, some aspects of the economy are worrying, mainly reflecting a too expansionary policy. Owing to the relaxation in both monetary and fiscal policy, as well as to continued intervention in the foreign exchange market, the Vietnamese authorities have regrettably not accomplished all the program targets. We fully support the thrust of the staff appraisal and strongly encourage the authorities to implement tighter monetary and fiscal policies.

As other speakers have already touched upon the most important issues, let me make only three brief remarks.

We fully agree with the staff that adjustment in the fiscal deficit over the medium term will need to place greater emphasis on expenditure restraint whereas further revenue measures should be formulated within the tax reform program. We welcome the statement that the fiscal deficit is expected to be reduced below the original program target of 4 3/4 percent of GDP. However, there seems to be a significant discrepancy between the share of consumption expenditures and the share of investment expenditure, the latter being too low to provide optimal support for growth of the economy.

Furthermore, a gradual reduction in the ratio of current expenditure to GDP would be desirable in order to increase government savings as, owing to the lack of a well-developed financial system, national savings--which remain relatively low compared with many other Asian countries--have to come mainly from government savings. Furthermore, I wonder how good the chances are for the projected increase in the national savings rate from 5 percent to almost 9 percent in 1994.

It is certainly unfortunate that according to the background paper a complete analysis of current expenditures is hampered by a lack of detailed data. It would have been helpful, in particular, if the "other" budget category, which accounts for nearly one third of current expenditures in 1994, could be analyzed in more detail.

On structural policy, the enterprise reform is proceeding in two stages. The state sector has so far been reduced by about one half to some 6,000 enterprises. During this first stage, the reregistration program, the hardening of budget constraints, the liberalization of prices, and greater autonomy in decision making, as well as other exogenous factors, contributed to a significantly improved financial position for state-owned enterprises. This was indeed remarkable. However, 6,000 such enterprises is still a large number. During the second stage, I understand that--among others--"equitization" of ownership is intended. However, the number of enterprises involved in equitization is small, namely, only 9 up to the end of 1994. I would invite the staff to elaborate on the authorities' approach to enterprise reforms and, perhaps, on a certain reluctance to proceed with privatization.

As already indicated in the staff report for the economic program (EBS/93/154), issued in September 1993, the authorities' approach to exchange rate policy would remain market determined. Interventions were intended only to smooth out short-term fluctuations rather than to guide the path of the exchange rate. Accordingly, the stock of net foreign assets at the end of 1993 was projected to remain of the same magnitude as at the end of 1992. In the course of 1993, however, net international reserves declined by almost 50 percent (EBS/94/105, Table 3), thereby keeping the dong relatively stable and financing almost 75 percent of the current account deficit. Apparently, the prevention of a much stronger depreciation also contributed to the sharp rise in imports. Therefore, we hope that the Vietnamese authorities, and reaffirmed by Mrs. Hetrakul, are offering more than lip service when they state their intention to allow the exchange rate to be primarily market determined.

With these remarks, I support all the proposed decisions.

Mr. Zoccali made the following statement:

Like other speakers, we are encouraged by the success so far of Vietnam's transition to a market economy. The challenge facing the authorities is to sustain buoyant economic activity and facilitate investment without endangering macroeconomic stability. In this regard, we are reassured by the staff's indication that trends in the first quarter are broadly consistent with the revised economic program for 1994 and that the newly established performance criteria for June and September 1994 seem attainable, in light of the credit restraint and fiscal adjustment measures recently implemented by the authorities. This said, fiscal and monetary measures aimed at checking domestic absorption are likely to prove insufficient to foster savings and competitiveness and sustain growth. As Mr. Sirat and Ms. Srejber have noted, we consider also that a more vigorous implementation of structural reforms is called for, including those outlined in Table 4 of EBS/94/105, particularly the elimination of obstacles to external trade and payments, the rationalization of tariffs, the development of a legal framework, and especially the overhaul of the state enterprises and the financial sector.

Similarly, domestic facilitating of external assistance and timely disbursements by the international community are essential. Resorting to midcourse alternative domestic fiscal actions to maintain the fiscal targets is, in our view, a second-best solution, given that these heighten uncertainty and often result in further distortions, including unanticipated commercial borrowing and rescheduling. In this connection, we would appreciate some updating from the staff regarding the status of the negotiations with private creditors aimed at rescheduling some $150 million in debt-service obligations arising from suppliers' credits contracted in 1992-93.

As we share the thrust of the staff appraisal and the comments of earlier speakers, we can support the proposed decisions.

Finally, on a related issue, we share the views of Mrs. Hetrakul and Mr Ismael regarding the need for a paper reviewing the 1982 guidelines on bilateral payments arrangements, last discussed on September 20, 1982. In this regard, the characterization of the bilateral payments agreement with Malaysia as an exchange restriction subject to approval under Article VIII, Section 2(a), on the basis of a literal interpretation of footnote 3 on page 3 of the staff paper on the review of bilateral payments arrangements (SM/82/169), seems to modify the prevailing view held until now that if participation in the arrangement were voluntary, it would not be deemed an exchange restriction regardless of the length of the settlement period specified. The behavior of economic agents seems to confirm the logic of that broader interpretation; as footnote 1 on page 15 of the staff report (EBS/94/105) shows, no transactions have so far occurred under this payments agreement. Consequently, until a comprehensive paper on the legal and economic consequences of bilateral payments arrangements is reviewed by the Board, we consider that the status quo in this regard should be maintained.

Ms. Patel made the following statement:

Since initiating stabilization efforts, the Vietnamese authorities have made much progress in many areas of policy implementation. Thus, while maintaining a tight reign on macroeconomic management, significant improvements were also made in reforming the financial system and liberalizing prices and the exchange rate regime. As a result, growth performance was better than initially envisaged, inflation abated to levels below the target, and the external position witnessed some amelioration resulting in the strengthening of the reserve position.

Notwithstanding these achievements, the authorities have experienced difficulties in complying with some of the performance criteria stipulated under the stand-by arrangement, resulting in weakened economic performance during part of 1993. However, the measures taken by the authorities recently, will enable them to correct the slippages and build on the initial achievements. In particular, the planned tightening of the fiscal and monetary stances are essential to the creation of an environment that is supportive of the program's goals. Above all, maintaining strict adherence to timely implementation of the policy measures envisaged under the revised financial program is most important for the success of the program.

Thus, it is worth noting that among the restrictive monetary measures implemented is the introduction, on a temporary basis, of credit ceilings for the commercial banks as a means of curbing the excessive credit to the private sector that was at the heart of the slippages. The intention of the authorities to develop market instruments of monetary control to replace the existing direct intervention is, indeed, more consistent with the ongoing deregulation of the economy. In this respect, it is critical that the Fund support the authorities with the necessary technical assistance.

On the fiscal front, it is reassuring to note that the authorities are willing to undertake the required revenue and expenditure measures that will further strengthen fiscal consolidation. The emphasis placed on introducing additional measures to both reform the tax system and implement expenditure cuts, mainly of unproductive activities, is commendable. The planned public expenditure review will enable the authorities to proceed with confidence in further streamlining expenditure, once the priorities are identified. The readiness of the authorities to undertake additional measures to avoid recourse to further domestic or external financing leads us to believe that the program targets will be met.

While considerable progress has been made in the implementation of structural reforms, it is essential that the authorities persevere with further economic liberalization, with special emphasis on accelerating public enterprise reform and building institutional capacity.

Timely and concessional external financial assistance will continue to be required to support Vietnam's transformation process and reform efforts. The authorities have over the past years demonstrated an unwavering commitment to the adjustment program, and financial support from the international community, including the Fund, is crucial and can only strengthen their resolve. I, therefore, can support the proposed decisions.

Mr. Kiekens made the following statement:

Although Vietnam still has one of the lowest per capita incomes in the world, it has turned in a remarkable macroeconomic performance over the past few years.

Vietnam has succeeded in maintaining a balance among price stabilization, economic growth, and the move to market principles. In 1993, economic growth was estimated at 8 percent, and inflation stood at 5.5-7 percent, which was substantially lower than forecast.

Good as these results are for a transition country, they are overshadowed by some problems. I will briefly comment on credit policy and the needed structural reforms in the banking sector.

We welcome the authorities' decision to put an end to the banks' overly generous credit policy. The various mechanisms now being introduced, such as credit ceilings, are a first step in the right direction. This process must be continued to forestall damage to such important fundamentals as price stability. Indirect policy instruments should be developed to monitor private credit flows in a more market-friendly way, and marketable instruments should be introduced to improve the intermediation process and mobilize private sector savings more efficiently. I understand that Vietnam's Treasury has started issuing six-month bills to support its policy, and an issue of three-year bonds is planned for June 20. It is indispensable for Vietnam to stimulate internal savings and investment and to obtain an adequate level of official development assistance.

Also called for is a more market-oriented exchange rate for the dong, which of course will pose difficulties in view of the great need to import equipment that is essential for Vietnam's reconstruction.

Even though the banking infrastructure has been improved recently, the large structural reforms required under the program remain absolutely necessary. The banking sector--the backbone of a well-functioning economy--is the weak link, and this must be reformed. I am sure that the Fund will be willing to provide still more technical assistance to facilitate the complete reform of the banking sector and the financial markets.

If Vietnam is successful in making full use of the technical assistance, foreign investment, and official development assistance that are available, and if sound basic macroeconomic policies are developed, this country will certainly be able to meet the conditions for obtaining an ESAF arrangement.

We support the proposed decisions.

Mr. Powell made the following statement:

The slippage on performance from the start of this program has been disappointing. While I can agree to the proposed waivers, rephasing, and other decisions, I must say that the jury is still out as to the success of the program.

Developments in the first quarter of 1994 do show some evidence of tighter monetary policy with the pace of expansion of net domestic assets and credit to the Government slowing somewhat. However, it is important that credibility of the program should be firmly established and maintained, through the achievement of the new performance criteria and through structural measures under the revised baseline. A successful track record under the stand-by arrangement, and avoiding further requests for waivers, will be required before the staff can move on to negotiating an ESAF-supported program. The June performance criteria will be particularly important in this context.

The authorities' readiness to tighten fiscal policy further should financing shortfalls emerge in 1994 is also important. Aid disbursements have been a problem so far. The programmed fiscal deficit for 1994 assumes an acceleration of aid disbursements, as well as a rescheduling of commercial credits contracted during 1992-93. In the event of financing shortfalls--for whatever reason--the balance of adjustment needs to be focused on the expenditure side of the budget without recourse to additional bank financing or new commercial external finance. A particularly worrying development last year was the contracting of supply credits with relatively short maturities. This type of borrowing may simply be storing up problems for the future.

More generally, the authorities need to pay close attention to maintaining their creditworthiness. This means not only a cautious approach to new commercial borrowing, but also building up a good track record of making payments to creditors on time.

I strongly support the staff proposal that intervention in foreign exchange markets be limited to smoothing short-term fluctuations. It is important that the authorities do not jeopardize the programmed modest buildup of reserves by supporting too high an exchange rate.

Finally, I welcome the progress on structural reforms during 1993. I support the authorities' intentions to abolish the remaining import quotas and the import licensing system, and I urge continued expansion of the right to conduct foreign trade by Vietnamese firms.

Mr. Keller made the following statement:

We very much welcome the progress made so far by Vietnam in stabilizing its domestic economy while continuing to grow vigorously. The fact that this development has been somewhat detrimental to the external balance proves the enormous catch-up potential of the Vietnamese economy on the one hand, and the fact that the country is at present near the maximum of its absorption capacity on the other. In these circumstances, there is no room for complacency with an expansionary economic policy stance.

Previous speakers have already commented extensively on Vietnam's economic performance. I would thus like to make some more general comments on the program environment and on its implementation, as we very much agree with the staff representative's statement that this is a crucial stage in Vietnam's relations with the Fund.

Unlike most countries in transition, the Vietnamese authorities enjoy the advantage of transforming their economy in a strong growth environment. While this may generally facilitate their task, mainly through better policy acceptance by the public, some particular challenges also spring from the high-growth environment. The first is to withstand the temptation to conduct too loose a monetary and fiscal policy and to resist giving in to the optimistic economic drive. Strong economic growth does not provide justification for such a policy, nor does it excuse it. The second is to persevere in implementing structural reform and in strengthening the institutional framework for future development. Like Mrs. Srejber and Mrs. Wagenhoefer, we feel that such reform is still weak, particularly with respect to financial sector reform and extensive privatization.

The staff report details that, indeed, the Vietnamese authorities have pursued a rather expansionary policy through the last quarter of 1993. Hence, it should not come as a surprise if the most important performance criteria under the stand-by arrangement have since been missed. We certainly do not doubt the Vietnamese authorities' commitment to effective policy actions, but one might have some reasonable doubts about their capability to handle adequately the present boom-and-reform situation. These difficulties could probably have been better taken into account in the design of the program, as they were not unknown to the Fund. Ever since Vietnam has been discussed in this Board, its difficulties in controlling monetary and credit aggregates in particular were highlighted. In this context, and unless decisive action is taken immediately, it will be extremely difficult to achieve the inflation rate target of 7 percent by year-end.

We appreciate the staff's explanation and candid assessment of Fund relations with Vietnam. Being aware of the difficulties in gauging early statistical information to assess the economic situation and to build a program upon it, we should accept the staff's explanations that the program was based on already outdated data for June 1993 in order to justify the present adjustments of performance criteria. However, like Mr. Kannan and Mrs. Srejber, we were struck by Mrs. Hetrakul's explanation of "unfamiliarity of the authorities with the procedures of the Fund-supported program." In sum, we would hope that the revised program, "prepared"--again quoting Mrs. Hetrakul's statement--"in order to place stabilization policies back on track and continue with the structural reforms needed to develop a market economy," will need no further accommodations. Furthermore, we hope that--despite the mentioned data problems or slow policy response in the past--the authorities will be in a position to take early action, if required, to correct policies, should performance again deviate from the projected path.

With these considerations in mind, we can support the proposed decisions. In the authorities transition to a promising emerging market economy, they also have financial assistance from Switzerland.

Mr. Giulimondi made the following statement:

Vietnam has achieved encouraging results over the past years. They can be summarized as sustained growth, low inflation, fairly satisfactory structural reforms toward a market economy, re-establishment of widespread international trade, and reintegration into the international financial community. Keeping in mind these advances and the candid admission contained in the statement by Mrs. Hetrakul about the Vietnamese authorities' inexperience with Fund procedures, one can view from the right perspective the deviation from several performance criteria under the current program and the request for a waiver of nonobservance and modification of the financial arrangement.

Of course, we do not underestimate the scope of the defaults in the program's implementation, or the risks involved in the program review and the release of purchases remaining under the stand-by arrangement and resources under the structural adjustment facility. At this stage of the discussion, and being in broad agreement with the staff's assessment, I will only remark on a point of major concern: the heavy dependence of the program on external financing.

I share the point made and the hopes expressed by Mr. Sirat on the challenges facing the Vietnamese authorities and the donor community in the coming months. However, we have to take into account the possible continued shortfall of external assistance.

The budget approved by the National Assembly in December 1993 projected an overall deficit 1.2 percent larger than envisaged in the program. The initial overestimate of external assistance and the need to bring the deficit back to the program target, as well as the means to achieve such a result by revenue measures and expenditures savings, avoiding both external commercial and domestic bank borrowing, have been recognized by the Vietnamese authorities. Preliminary data for the first quarter of the year now suggest that the program objectives are being maintained. We encourage the authorities to meet the goal that post-budget fiscal measures be incisive enough to allow a deficit reduction even slightly greater than required by the program. Yet, questions may arise as to the Government's authority to reduce expenditures beyond the targets assigned by the National Assembly through the budgetary law, or as to the willingness of the Assembly to eventually endorse further restrictive measures. A brief comment on the attainability of this objective for the remainder of the year from this point of view would be appreciated, in view of the fact that difficulties in finding external assistance and nonbank domestic financing are likely to arise even at an improved level of budget deficit.

Second, and correlated, the possible continued shortfall in projected external assistance raises the question of compressing capital spending. On this point I share the concern raised by Mr. Zhang and other speakers. The public sector investment program is focused on projects ranging from electrification to road and waterway development. A possible policy dilemma exists between cuts in capital spending and unlikely additional fiscal actions on the one hand, and renewed, unwanted recourse to bank borrowing, encouraged by the still declining inflationary trend, or to commercial borrowing on the other. As such, close consultation with the authorities to examine the causes of cost overshooting of initial projections might be useful. The cost of the north-south power line has more than doubled so far; the initial underestimate of actual future costs, eventually combined with inefficiencies in public works management, if repeated, may exert further pressure on the budget or force the curtailment of much-needed investment projects. A brief comment by the staff on this point would be appreciated.

With these remarks, we support the proposed decisions.

Mr. Daïri made the following statement:

The staff report on Vietnam's performance and policies and Mrs. Hetrakul's statement confirm that the economy is capable of generating strong growth with controlled inflation, while undertaking structural adjustment. Nonobservance of some performance criteria under the stand-by arrangement should be attributed mainly to overextension of credits owing to the authorities' desire to accelerate growth. The authorities' quick recognition of slippages and their proper reaction, which brought the program back on track, is commendable. We are in broad agreement with the thrust of the staff appraisal and recommendations, and therefore our comments will be limited to a few areas of interest.

As a positive response to adjustments, the current year's output should turn out to be even better than projected in the report. For one thing, the lifting of the U.S. embargo will further enhance external trade. Moreover, the large inflow of capital and foreign aid pledged by donors in late 1993, which is expected to pour close to $2 billion into the country, should help improve productive capacity. The authorities' intention to move toward industrialization with emphasis on an export-oriented strategy and exploitation of comparative advantage is an important step in the right direction. They are encouraged to attach high priority to modernization of the agricultural sector, which still uses substandard techniques. The authorities are also advised to mobilize domestic resources for investment needs. We are pleased to note that the authorities are aware of the low level of savings, and national savings are projected to grow, as a consequence of financial policies, from 7 percent of GDP in 1993 to 10.5 percent of GDP in 1994. Efforts should be continued in this area until domestic savings reach the level of investment needs.

On the fiscal front, the authorities will need to continue their tight policy. Though the overrun on last year's budget was financed through better than expected revenue collection and foreign borrowing, the same may not be repeated. First, revenue is unlikely to grow at the exceptional pace of last year. Second, as envisaged in the program and emphasized by Mr. Waterman, Ms. Lissakers, and Mr. Shaalan, the country should refrain from short-term borrowing. We, therefore, fully support the authorities' ongoing efforts to cut expenditures. Paramount among them is the plan for an administrative reform that involves the merger of several ministries and a reduction in civil service employment. A matter of concern here, as mentioned by Mr. Zhang, is that the spending cut of D 1 trillion referred to in the report should come mainly from trimming the capital budget. Like Ms. Lissakers, we are also concerned about the category of "other current expenditure" which rose by almost 2 percent of GDP in 1993. We fully share the staff's view that there is a need for more transparency and a further breakdown of this category.

Monetary policy should provide the main nominal anchor for the stabilization of the economy during the program. Containment of inflationary pressures will require continued vigilance over monetary developments and especially over the velocity of money, which remains high even after two consecutive years of decline. To this end, the authorities will need to keep real interest rates positive and stand ready, as suggested by the staff, to use other monetary instruments. We are pleased to note that in the current program, there would be no net bank financing of the budget, though concerns may be raised as to the level of government bank financing in recent months. We therefore endorse the authorities' recent tightening of credit ceilings, as well as the increase in refinancing rates for all commercial banks. We are also sympathetic toward the authorities' selective changes in reserve requirements and would appreciate staff comments on its rationale for supporting a unified rate of reserve requirements.

In the medium term, Vietnam will need to restructure its financial sector for efficiency purposes. To increase, for instance, the low rate of private savings, high positive interest rates may be a necessary, but not sufficient, condition. Resuming confidence in the banking system and increasing the efficiency of financial intermediation are equally important. To this end, Vietnam will first have to furnish the viable legal and regulatory framework. Enhancing the supervisory capacity of the State Bank is also crucial to ensure that these regulations are properly observed.

On external policies and prospects, the authorities should be commended for their intention to maintain a market-determined exchange rate regime. The Government's decision to stop supporting the dong through intervention has the dual benefit of building international reserves as well as fostering competitiveness. Additionally, this policy will secure long-run stability in the exchange rate and contribute to an increase in confidence and lowering of inflationary expectations.

Vietnam's medium-term balance of payments outlook is promising, although it remains sensitive to a number of exogenous factors. Maintaining the momentum of adjustment will not only ensure the achievement of balance of payments viability , but also enhance the prospect of securing concerted support from the international community.

Before leaving the subject of external policy, let me commend the Vietnamese authorities for their continued efforts to liberalize external trade. The pace and magnitude of the further adjustments needed have been rightly emphasized by the staff. I would only underscore the technical assistance that may be needed in this area, and that should be provided by the Fund in a timely manner.

As outlined in Table 4 of the Appendix to the staff report, some encouraging steps have been taken in restructuring and privatizing. Enterprise reform has made impressive progress and the state sector has been reduced by about one half in the first phase of the program. We join Mr. Sirat in encouraging the authorities to press ahead with the next phase, which seems to be more protracted and challenging.

Finally, we welcome the recognition of the importance of a carefully designed and well-targeted safety net in the program. However, the staff report contains only a brief discussion of safety net arrangements. While perhaps this is a task to be entrusted to the World Bank, we wonder whether the absence of an adequate and well-funded safety net may not appear to be a major constraint on the authorities' willingness to accelerate the pace of restructuring efforts.

The program before us is comprehensive, well articulated, and deserving of Fund support, and we have no hesitation in supporting it.

We also join the position of Mrs. Hetrakul and Mr. Zoccali on the bilateral payment agreement with Malaysia and would like to see a staff paper on this matter.

Mr. Galicia agreed with the assessment of the staff and Mrs. Hetrakul that economic progress by Vietnam in many areas had been meaningful. The slippages under the program related to performance criteria for end-December 1993, as well as end-March 1994, had been comprehensively addressed in the authorities' program for 1994. It was encouraging that, with implementation of the corrective policies, the program supported by the stand-by arrangement was back on track and medium-term prospects remained favorable. For those reasons, he supported the proposed decisions on the stand-by arrangement and on the purchase under the systemic transformation facility.

Concerning the proposed decision on the exchange system, Mr. Galicia continued, he supported Mrs. Hetrakul. The bilateral payments agreement between Vietnam and Malaysia should not be considered an exchange restriction subject to approval under Article VIII, Section 2(a). He believed, like Mrs. Hetrakul, that those agreements were of a voluntary nature and did not constitute an exchange restriction.

Mr. Jamnik remarked that Vietnam's record of servicing its external obligations was worrying. It was difficult to understand, for example, why Vietnam would reschedule suppliers' credits from 1992 and 1993. Indeed, on first reading, doing so might appear to be a back-door attempt to circumvent the limits on the contracting of nonconcessional external debt. Perhaps the staff could elaborate on the rationale behind that rescheduling. In any case, the rescheduling of suppliers' credits sent alarming signals to potential creditors and would render access to new credits more difficult and more expensive at a time when the country was striving to decrease the cost of its financing. Also, the authorities appeared to be putting too much emphasis on foreign direct investment, which, although important for the economy, could not be counted on to meet a large share of Vietnam's external financing needs.

We urge the Vietnamese authorities to implement a more ambitious privatization program, as public sector enterprises continue to play a dominant role in the economy, Mr. Jamnik stated. The situation tended to put pressure on the central bank to extend concessionary credit and was not conducive to a dynamic market-oriented economy. Indeed, the extent of the continued influence of the command economy was evidenced by the fact that of the 200 priority projects drawn up by the Government to attract foreign investment, none of the proposed Vietnamese counterpart companies were in the private sector.

Mr. Posthumus said that he supported the proposal of Ms. Lissakers to publish the interesting background paper on recent economic developments.

The staff representative from the Central Asia Department explained that, on exchange rate policy, the staff believed that with restrained fiscal and monetary policies, the exchange rate could be kept broadly stable and intervention by the authorities in the market should be limited. He would not go so far as to say that the State Bank should not intervene at all, because, as a recipient of a large amount of foreign exchange receipts, it was a provider to the market. The authorities' position was evidenced by their actions: they intervened to support the dong in a consistent manner. They looked at one variable--the inflation rate--in their macroeconomic policy model; and they considered a stable exchange rate an important element in keeping the inflation rate down. Given the other policies available, the authorities believed that the only option was to intervene and sell the foreign exchange reserves, as they had done in 1993. He would observe that the policy advocated by the staff was reasonably clear, and it had not been followed, which constituted a serious deviation from the program.

He agreed with Ms. Srejber on the need to strengthen structural reform, the staff representative went on. That weak area had not been overlooked in the stand-by arrangement, although the staff had not included structural performance criteria; nevertheless it had tried to maintain a momentum of structural reform through its many discussions with the authorities. State enterprise reform was crucial, and the first phase--halving the number of enterprises--had been very successful in improving the financial situation. The next stage--dealing with the remaining 6,000 enterprises--would be more difficult. The World Bank had a project in that area, and the authorities had stated that they wished to reduce the 6,000 enterprises to 300 strategic enterprises and equitize or open to joint ventures the remaining enterprises. Although off to a slow start, recent statements by high-level officials in Vietnam were encouraging; they had recognized the problems and the need to act. New responsibilities had been created within the Ministry of Finance to accelerate the process of state enterprise reform--a major element in any future ESAF-supported program.

On the attainability of the fiscal targets, he had mentioned the need for action and for flexibility in fiscal management, the staff representative said. The National Assembly did not represent an obstacle, because it did not support the requests for high expenditures and, following the [budget] debate, had stated that current expenditures could be cut by another 5 percent. Of course, no one wanted to advocate compression of capital spending; but sometimes that was a difficult but preferred alternative to imprudent commercial borrowing.

The Vietnamese authorities had recently stipulated dual reserve requirements depending on the type of deposit, the staff representative remarked. That measure added to the many distortions within the system. The staff's policy advice was fairly standard: remove the distortions caused by non-uniform reserve requirements and, admittedly more important, implement a correct maturity structure of interest rates. In the case of Vietnam, the staff would encourage the authorities to improve the situation by acting to at least remove the distortion related to reserve requirements.

Suppliers' credits for 1992-93 had increased debt service by 1 1/4 percent of GDP, which unfortunately raised some doubts about the Vietnamese authorities' ability to repay, the staff representative commented. The adjustment measures required to fully meet that debt would have affected growth and import targets, and the mission had considered that spreading out the debt was the best solution in the circumstances. The authorities had been in touch with the companies involved--including some Japanese companies--and although final details of the debt-rescheduling negotiations were not available, the authorities had indicated their expectation of a favorable outcome.

On publication of the background paper on recent economic developments, the staff would produce an economic review, based on that paper, which could be released to the public in the following month or so, the staff representative from the Central Asia Department said. The economic review would not include some sensitive material that the authorities would not wish to be released.

The Chairman commented that the agreement of the authorities would first have to be obtained, but he was certain that they would recognize the benefits of having the publication made available to the international financial community.

Mr. Posthumus observed that Fund advice on exchange rate policy had also been given to a few other countries--including some in his constituency--urging them to let the exchange rate float with only occasional intervention to smooth short-term fluctuations. However, those countries soon found themselves in the same situation as Vietnam, partly because of political pressure and partly because of the difficulty in judging the extent of the fluctuation and thus the extent of the intervention. In such cases, Fund monitoring should be close, at least for some time, to assist in following policy and avoid having the program go off track. Particularly important in that connection was technical assistance to the central bank authorities.

Mr. Shaalan said that he supported Mr. Posthumus's call for caution in staff advice in that policy area, particularly with respect to intervention when a country was required to respect a floor on net international reserves.

The Chairman agreed that the staff must be cautious in such policy matters, which were, nevertheless, at the center of Fund surveillance, and of stabilization programs in many cases.

The General Counsel recalled that the bilateral agreement between Malaysia and Vietnam was among a series of bilateral payments agreements that had been considered by the Board on September 15, 1993 (EBM/93/132) during Malaysia's 1993 Article IV consultation discussion. At that time, however, there had been insufficient factual information to make a determination as to whether this agreement, as well as the others, gave rise to an exchange restrictions. Since then, information had become available--in particular and most relevant, it had been clarified that the settlement period for the clearing of official balances under the agreement exceeded three months, which was the maximum period permitted by the decision of the Fund on bilateral payments agreements.

At the time of the 1993 Board discussion on Malaysia, the staff had been asked to prepare a paper explaining the legal aspects of bilateral payments arrangements, the General Counsel recalled. That paper was under preparation; the delay was due to the number of other priority tasks but also and notably to the difficulty of defining in simple terms the typical bilateral payments agreement. It had changed considerably since the beginning of the Fund, and a comparison of staff economists' papers written in the late 1940s with those written in the early 1980s revealed substantial differences in the types of arrangement and the terminology.

The footnote mentioned by Mr. Zoccali reflected those semantic problems, the General Counsel continued. Terminology, rather than a legal principle, was the point of that footnote, which should not be read, therefore, as limiting the substantive principles stated in the text. In a typical payments agreement, there were two levels: the channeling of payments between individual importers and exporters, and a clearing mechanism at the central bank level. Different modalities were possible.

At the level of individual importers and exporters, the agreement might be mandatory or optional. If the system was not mandatory, there was no exchange restriction at that level; nevertheless, that agreement would have an economic impact if, for example, there were incentives for going through that account and diverting trade from other countries, say with a better exchange rate. This would be a legal issue for the Fund to examine in order to determine whether such arrangement is a discriminatory currency arrangement; and one of the purposes of the paper under preparation would be to look into the discriminatory aspects.

But the problem in the agreement between Vietnam and Malaysia was not at the individual level, since it was optional for individuals, and therefore did not give rise to an exchange ratification at that level, the General Counsel explained. Rather, the problem lays at the official balances level. At the higher level of official balances, the problem had to be put in perspective. Obviously, the agreement between the central banks, acting with the approval of their governments, was legally voluntary. But the Fund's legal system was not based on contractual agreements freely entered into between parties, but rather on a multilateral system enforced by the Fund sometimes against the will of two contracting parties.

That issue had been faced by the Fund in the landmark sterling area case of 1968, the General Counsel noted. At that time, the Bank of England and most of the central banks of the sterling area had entered into an agreement whereby the Bank of England agreed to maintain the dollar value of their holdings of sterling and, as a counterpart, those central banks agreed not to request the Bank of England to convert their sterling holdings into convertible currencies. When the Board considered the matter, the position taken by the staff had been that, although the agreement was of a voluntary nature between central banks acting on behalf of their governments, it was a violation of Article VIII, Section 2(a). It was a restriction on the making of current payments because those holdings of sterling that had been acquired as a result of current transactions were not freely available to make payments to other creditors, but instead were treated like frozen reserves.

The Board had approved the position of the staff--that two Fund members could not agree between themselves that one of the two would have its reserves frozen with the other--the General Counsel stated. There was an obligation for a Fund member to convert, on demand, official balances of another member with its central bank. In that case, however, the Board had granted approval for the maintenance of that restriction for a limited period.

A similar question had arisen with respect to bilateral payments agreements, the General Counsel continued. In SM/82/169 (8/17/82) there was a brief description of the same legal position on bilateral payments agreements, namely, that there was an obligation for central banks to convert the official holdings of another central bank with itself when they were acquired under the agreement as a result of current transactions.

However, it was recognized that, perhaps because of the specific nature of those agreements, as long as settlements of the official balances were made within a three-month period, there would be no violation of Article VIII, Section 2(a).

If the view was taken that the position stated in the 1982 paper and approved by the Board applied to the agreement between Vietnam and Malaysia, then the official balances must be settled within three months, the General Counsel explained. This was the view taken by the staff and therefore, since those members had agreed to settle the official balances beyond that period, the draft decision was proposed. If, however, the view was taken that the agreement is not subject to the 1982 decision, then it would be the precedent of the sterling area case that would apply. And in that case, it was decided that settlement was due on request, without a grace period. Thus, the three-month grace period for settlement is to the benefit of the authorities.

The problem here arose because, in the view of the Vietnamese authorities, individuals were free to operate outside the payments agreement mechanism, and thus the agreement did not constitute a payment agreement, the General Counsel went on. Nevertheless, it was clear from the 1982 paper that even if the agreement only provided for a clearing account mechanism, the rule on settlement periods of official balances remained the same.

The practice with respect to settlements periods of official balances had evolved to consider periods up to three months as not undue for that purpose. The footnote in the 1982 paper stated that, in instances where settlement intervals exceeded three months, if the parties involved in the transaction had the option to settle through normal commercial channels as individuals, the clearing arrangement would not be regarded as constituting a bilateral payments arrangement. The issue was one of semantics: the footnote did not mean that clearing arrangements did not give life to exchange restrictions. Therefore, the rule remains the same. Thus, whether an arrangement was a clearing arrangement or bilateral payments arrangement, if the settlement period exceeded three months, in his view, it was subject to Board approval. Otherwise, the precedent was the sterling area case, whereby the grace period did not apply and settlement had to be made on request.

Mr. Zoccali commented that he would not wish to be seen as defending bilateral arrangements, but it should be noted that in the 1982 paper, there was no substantiation behind the three-month period, rather than four or five months, as an acceptable cutoff. That issue should be taken up. But more important, it was necessary to substantiate perceived changes in Fund policy, particularly when many arrangements, both bilateral and multilateral, had been working well. For example, payments arrangements in Latin America had not given rise to trade distortion problems, even in the midst of the debt crisis affecting Latin America in the 1980s. Therefore, before taking up issues or establishing precedents in a piecemeal fashion, it was essential to look not only at the legal substance but also at the economic implications.

The aim of the institution was to improve the effectiveness of Fund surveillance, Mr. Zoccali continued. In that regard, priorities should be established. Bilateral arrangements should be considered in a comprehensive manner so as to reach a formal and explicit conclusion; in that way, countries would be made aware of the issues and the effect on their own bilateral arrangements.

Mrs. Hetrakul said that she supported Mr. Zoccali's request for a formal discussion and decision by the Board before taking any action in the case of Vietnam.

The General Counsel pointed out that, in the sterling case, there had been no grace period. In 1982, when the paper on payments arrangements was prepared, the staff had determined that in Latin America the arrangements period was for a two-month settlement period. Thus, it had been thought that a three-month settlement period was generous, and, for that reason, that period had been proposed to the Board as a maximum grace period. The Board could, of course, take a decision to lengthen, or shorten, the period. Meanwhile, the staff was proposing to apply the existing decision.

Mr. Zoccali reported that, in Latin America, the compensation mechanism for clearance among central banks was every four months.

Mr. Daïri noted that Mrs. Hetrakul had stated that the decision on Malaysia's so-called restrictions had been postponed until issuance of the staff study under preparation. For reasons of equity, he proposed that the draft decision on Vietnam be postponed until the study was issued.

The General Counsel, responding to Mr. Zoccali, said that the longer clearance period in Latin America had been noted and could provide a reason for the Board to decide to lengthen the period. As to the decision on Malaysia, it had been postponed because the facts had been unavailable at that time, not because the legal issue was unclear.

Mrs. Hetrakul remarked that she felt strongly that the issue had to be submitted to the Executive Board for consideration and approval before any decision could be taken. For that reason, she proposed that paragraph 2 in the draft decision on the 1994 consultation be amended; "and restrictions arising under a bilateral payments agreement with one Fund member, which are subject to approval under Article VIII, Section 2(a), and "and urges elimination of the measures that are subject to Article VIII" should be deleted until formal discussion by the Board and its approval had been reached.

The General Counsel remarked that he would have a problem with that amendment, because one member would be exempted from a general decision that was being applied to other members.

Mrs. Hetrakul observed that, to her knowledge, the present instance was the first time such a decision had been taken. Malaysia had had bilateral agreements with other countries as well, and in those countries' Article IV consultation discussions no such decision had been taken. Therefore, the formal Board discussion should take place prior to taking the decision.

The General Counsel said that the decision had been proposed in this case because, for the first time, the facts were available and the staff could inform the Board that, in its judgment, the three-month settlement period was being exceeded. A similar decision had been taken for Malta, Bangladesh, and others, who would now perceive that the Fund had treated them unfairly if Vietnam were exempted from the same decision.

Mrs. Hetrakul recalled that Malaysia had bilateral payments agreements with other countries, particularly in Latin America, but when those countries had been discussed by the Board, their payments agreements had not been identified as giving use to exchange restrictions subject to approval under Article VIII. The Board had asked the staff to prepare a paper on the issue on September 15, 1993, and that paper should be studied before action was taken with respect to any country.

Mr. Zoccali commented that there was a clear perception of a change in policy on behalf of some members. Bilateral or multilateral arrangements required simultaneous action by two or more countries, and if that process was hindered by the lack of an updated discussion since 1982, the relations between those countries would be negatively affected. The first issue was that the General Counsel had mentioned that if the system was optional at the level of importer or exporter, there was no exchange restriction--an important point. The second issue was that no substantiation had been presented of why the three-month period was preferable to, say, four months. The third issue was the lack of Board discussion since 1982. On that basis, there was merit to the request of Mrs. Hetrakul for a Board discussion of the matter before generalizing that precedent.

The General Counsel recalled that some countries had not disputed the finding of a restriction and had been willing to cooperate, but that the other party to the payments agreement had argued for maintaining a period in excess of three months.

The Chairman said that the present discussion certainly justified a review of the issue in the following months. But it was more difficult to argue for suspension of the application of an existing decision. Apparently, in some cases, the decision had not been applied because facts had not been available or provided, but in others it had been applied, and he could not recommend that any country be exempted from its application.

Ms. Srejber remarked that the crucial rule was that, until a policy had been changed, the old decision must be upheld. The arguments of Mr. Zoccali and Mrs. Hetrakul for changing the policy were convincing, but meanwhile the present decision should be observed.

Mr. Posthumus acknowledged that, from the point of view of Mrs. Hetrakul, the present situation was awkward; but to perpetuate that situation could present further problems. Therefore, his first reaction was to support the General Counsel's position.

Mr. Wire said that he also supported that view. Although he had some sympathy for the arguments raised by Mr. Zoccali and Mrs. Hetrakul, among others, suspension of the application of the decision in the present instance could open up the broader question of suspension of all Fund rules for whatever reason.

The General Counsel, replying to a question raised by the Chairman, stated that a short paper on adjustment of the settlement period could be prepared. However, a detailed legal analysis would take more time.

The Chairman noted that a review of the restrictive aspects of bilateral payments arrangements would be most helpful to the membership. The paper could be circulated before the Annual Meetings for discussion thereafter.

Mrs. Hetrakul remarked that the suggestion to publish the background paper on recent economic developments was very welcome, and the details would be agreed by the staff and the authorities. She was grateful to management and staff for their not always easy and smooth task in setting up the economic and structural program for Vietnam. Their strenuous efforts and concerns at all stages were highly appreciated.

The Vietnamese authorities wished to convey to the Board their firm commitment to continue the comprehensive structural reform program with a framework of prudent fiscal and monetary policies, as underscored by the economic program, Mrs. Hetrakul stated. The authorities had reaffirmed their intention to take additional stabilization measures, if necessary. As domestic resources would not be sufficient to fund their adjustment and reform efforts, the authorities realized that further support from the international community was important. In that respect, the authorities would be more cooperative with their donors and refrain from contracting new external commercial borrowing of less than 12 years' maturity during the stand-by arrangement program period.

Concerning exchange rate policy, she had no information other than that provided by the staff, Mrs. Hetrakul continued. She could only reiterate the authorities' intentions to limit their intervention to smoothing out short-term fluctuations, and not to oppose market trends. Technical assistance in that area would be appreciated.

She had already expressed her views on the bilateral payments agreement and would not repeat them, Mrs. Hetrakul noted.

Finally, she thanked the Board for its willingness to support Vietnam's continuing structural adjustment efforts through the approval of the stand-by and STF arrangements, Mrs. Hetrakul said. She hoped that, with more technical assistance, the Vietnamese authorities would become more familiar with the procedures of Fund-supported programs and could request an arrangement under the ESAF in the near future.

The Chairman made the following summing up:

Executive Directors commended the authorities on the progress made in normalizing Vietnam's relations with the international financial community since the clearance of arrears to the Fund. They observed that Vietnam was well positioned for rapid economic development over the coming years, provided sound policies were followed. Directors noted that during 1993 output growth had continued to be strong and a further reduction in inflation had been achieved. However, Directors were concerned over the deterioration of the external position that had resulted from the relaxation of financial policies for much of the year. Directors regretted that the policy slippages had led to the nonobservance of performance criteria under the stand-by arrangement, but they were encouraged by the authorities' efforts to tighten financial policies with a view to bringing the program back on track.

Directors particularly welcomed the steps taken to control domestic credit expansion; in view of lingering data problems, credit control was an area that called for considerable caution. Directors also observed that during a transitional period, bank-by-bank credit ceilings and quantitative limits on State Bank refinancing were necessary--as a second best--for the achievement of monetary goals. Directors noted that these measures would be reinforced by recent increases in refinancing rates and by stricter enforcement of reserve requirements. Speakers indicated that domestic interest rates should be maintained at least at present levels until a sustained deceleration in credit expansion had been achieved, paying due regard to both the inflation and balance of payments targets. Looking to the future, Directors encouraged the authorities to develop indirect instruments of monetary control and welcomed the plan to soon establish an auction for government securities.

Directors noted that the fiscal targets for 1993 were broadly observed, with the strong revenue performance during the year offsetting the rapid rise in expenditure. However, they observed with concern that the financing of the deficit involved commercial external borrowing contracted on inappropriately short terms. In regard to the 1994 budget, Directors welcomed the recent revenue and expenditure measures that were expected to reduce the fiscal deficit below the original program target. They noted, however, that securing appropriate budgetary financing would still be difficult, particularly given the slow pace of aid disbursement. Directors indicated that the authorities should make efforts to mobilize additional domestic nonbank finance and external concessional aid. In this latter context, Directors emphasized the need to strictly limit, and, preferably, to abstain from, the contracting of further external commercial debt. Directors urged that, if financing shortfalls persisted, the authorities should implement the contingency fiscal measures envisaged under the program. Directors underscored that in curtailing current expenditure growth, the authorities should make efforts to redirect expenditure from unproductive uses to priority economic and social services.

Directors supported the authorities' intention to follow a policy of a market-determined exchange rate. On exchange market intervention to support the dong, Directors emphasized that exchange rate stability should be pursued through the implementation of prudent financial policies. Directors stressed that following the very sharp reduction in net international reserves in 1993, the authorities should aim to partially rebuild reserves in 1994. To this end, the authorities should be prepared to make appropriate adjustments to demand-management policies as required.

Directors welcomed the headway made in structural reforms and urged that further progress be made in revising the legal framework and in its implementation for private sector initiative and for financial institutions. They commended the authorities also for continued progress in consolidating and closing state-owned firms. In the context of redundancies arising from enterprise restructuring, Directors observed that compensation and retraining schemes were relatively well advanced given the low level of per capita income. Nevertheless, they urged the authorities to make further progress in the development of the social safety net. Directors urged the authorities also to move forward rapidly with plans for liberalization of the import permit and licensing system, and they welcomed the introduction of tariffs in lieu of import quotas.

In conclusion, Directors emphasized that firm commitment to macroeconomic stabilization should be supplemented by the Vietnamese authorities with more vigorous and comprehensive action in the area of structural reforms, in order for Vietnam to advance to balance of payments viability over the medium term. Directors also emphasized that this process and the sustainability of high growth rates also depended upon the attraction of foreign direct investment and the more timely availability of concessional external assistance. Directors hoped that a good track record under the stand-by-supported program would help to pave the way toward the conclusion of an ESAF arrangement for further use of Fund resources. They also noted that it would be important for the authorities to press forward with the regularization of Vietnam's relations with all creditors. Finally, Vietnam was encouraged to make best use of Fund technical assistance to overcome continuing data problems.

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

The Executive Board took the following decision:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Vietnam's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1994 Article XIV consultation with Vietnam, in the light of the 1994 Article IV consultation with Vietnam 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/94/105 are maintained by Vietnam under the transitional arrangements of Article XIV, Section 2, except (i) exchange restrictions evidenced by certain external payments arrears, and restrictions arising under a bilateral payments agreement with one Fund member, which are subject to approval under Article VIII, Section 2(a); and (ii) the multiple currency practice arising from a 5 percent tax on the remittance of profits from foreign direct investment, which is subject to approval under Article VIII, Section 3. In view of the authorities' intention to eliminate all external payments arrears by end-September 1994, the Fund approves the retention by Vietnam of the restrictions evidenced by these arrears until end-September 1994. The Fund encourages Vietnam to remove the remaining restrictions maintained under Article XIV and urges elimination of the measures that are subject to Article VIII.

Decision No. 10701-(94/52), adopted
June 8, 1994

The Executive Board, with one abstention, took the following decisions:

Stand-By Arrangement - Review and Modification

1. Vietnam has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for Vietnam (EBS/93/154, Sup. 3) and the last paragraph of the letter of the Governor of the State Bank of Vietnam dated September 11, 1993.

2. Vietnam has also requested an extension of the period of the stand-by arrangement through December 31, 1994 together with a rephasing of the remaining purchases thereunder.

3. The letter of the Alternate Governor for Vietnam in the Fund dated May 14, 1994, with attached memorandum on economic and financial policies, shall be attached to the stand-by arrangement, and the letter dated September 11, 1993, with annexed memorandum, shall be read as supplemented and modified by the letter dated May 14, 1994 and attached memorandum.

4. Accordingly,

(i) The period of the stand-by arrangement for Vietnam is extended through December 31, 1994.

(ii) Paragraph 2(a) of the stand-by arrangement is amended to read as follows:

"Purchases under the arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 84.6 million until August 31, 1994; and the equivalent of SDR 108.8 million until November 31, 1994."

(iii) The performance criteria set out in paragraphs 3(a)(i), (ii), (iii), and (iv) and paragraph 3(b)(i) of the stand-by arrangement shall be as specified in Attachment II to the memorandum on economic and financial policies attached to the letter of the Alternate Governor for Vietnam in the Fund dated May 14, 1994.

5. Paragraph 3(a)(v) of the stand-by arrangement is amended to read:

"if Vietnam fails to fulfill its intentions regarding the elimination of external payments arrears by end-September 1994; or"

6. The Fund decides that the review contemplated in paragraph 3(c) of the stand-by arrangement is completed, and that notwithstanding paragraphs 3(a)(i), (ii), (iv), and 3(b)(i), Vietnam may proceed to make purchases under the arrangement.

Decision No. 10702-(94/52), adopted
June 8, 1994

Purchase Transaction - Systemic Transformation Facility

1. The Fund has received a request by the Government of Vietnam for a purchase equivalent to SDR 12.08 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993).

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

Decision No. 10703-(94/52), adopted
June 8, 1994

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

4. INCOME POSITION FOR FY 1994; NET INCOME TARGET FOR FY 1995 AND RATE OF CHARGE; AND BURDEN SHARING

The Executive Directors considered a staff paper on the review of the Fund's income position for financial year (FY) 1994 and the rate of charge for FY 1995 (EBS/94/100, 5/13/94; and Sup. 1, 5/31/94).

The Chairman noted that Executive Directors had discussed in various forums the issues related to Fund income, and he appreciated their efforts to find common ground and appropriate solutions--even if those had to be, for all concerned, second- or third-best options.

The staff had proposed three decisions for adoption, the Chairman said: on the disposition of net income for FY 1994, the determination of the net income target and rate of charge for FY 1995, and the continuation of burden sharing for the remainder of FY 1995. While the decisions were open to discussion, and management and staff were ready to facilitate a consensus, he would remind Directors that the aim of the proposals was to preserve the financial integrity of the Fund. Therefore, he considered it essential that the decisions be adopted, while noting that the second and third decisions required a majority of 70 percent. Perhaps he could facilitate a consensus--without repeating the material provided by the staff for recent formal and informal discussions on precautionary balances, burden sharing, and Fund income--by highlighting a few key aspects of the decisions.

First, the staff proposed continuation for FY 1995 of the net income target of 5 percent of reserves at the beginning of the financial year, the Chairman continued. The proposed accumulation of reserves for FY 1995 would amount to SDR 85 million, and total precautionary balances, including the Special Contingent Accounts, would increase by SDR 278 million. In his view, the programs supported by the use of Fund resources warranted a rate of accumulation of reserves of the order contemplated in the draft decision.

Second, the staff proposed that at the current SDR interest rate of 4.14 percent, the Executive Board would need to agree on a coefficient for the rate of charge of 115.1 percent of the SDR interest rate, as reflected in the second draft decision, the Chairman stated. Historically, that coefficient was relatively high, but only because the SDR interest rate was at its lowest point since 1978, and a number of Directors had indicated--quite reasonably--that, given the tightening of monetary policy, particularly in the United States, the SDR interest rate might rise, rather than fall, over the balance of the financial year. While the Board would have the opportunity to review the charges coefficient at the midyear review of the Fund's income position in December, it would be useful to agree now that if net income was in excess of target at year-end, any excess income should be returned in the form of a retroactive reduction in the rate of charge after the end of the financial year, as had been suggested in the past. It might also be reasonable to contemplate that, conversely, any shortfall in Fund's income position should be met by an appropriate increase in the net income target for next year.

Third, on April 29, the Executive Directors had decided to implement the burden sharing decision until the end of July, to reduce the contributions by debtor countries to the second Special Contingent Account (SCA-2) to the equivalent of 4 basis points on the rate of charge from 26 basis points, and to cap the debtors' contribution to the SCA-2 at SDR 250 million in line with the intended contribution, the Chairman recalled. He hoped that Directors would decide to extend the burden sharing decision and to retain the present rate of contribution to the SCA-2. The burden sharing decision was not liked, because no one liked the existence of arrears to the Fund, but it had served the Fund well since 1987. The Fund's balances in the first Special Contingent Account (SCA-1) at SDR 550 million and in the SCA-2 at SDR 637 million provided a critically important element of the Fund's overall prudential position. Perhaps even more essential, the Fund's income was also fully protected against deferred charges which were offset in full by the contributions of debtor and creditor countries. It was noteworthy that the success of the arrears strategy had already permitted refunds to members amounting to about one half of the amount paid to cover deferred charges. Those charges were expected to amount to SDR 80 million in the following year, and, without burden sharing, the Fund would experience a significant income shortfall. The burden sharing decision must be maintained in order to continue the necessary accumulation of reserves and to offset deferred charges, thereby helping to maintain the Fund's financial strength in the present uncertain times.

Finally, many Directors were interested in the forthcoming staff analysis of alternative ways of financing the Fund, including the suggestions put forward by Mr. Posthumus in 1992, which could involve an amendment of the Articles, the Chairman commented. As indicated at the time of the Board's discussion of the work program, the staff would issue a paper in early July on various alternatives for financing the Fund, and its consideration before the recess might prove to be an appropriate occasion for discussing the structure of burden sharing over the medium term.

Mr. Dorrington made the following statement:

> At the informal meeting on May 23, I said that I would judge any proposals on the issues under discussion today according to whether, when taken together, they are fair, reasonable, and prudent. I would like to examine the staff proposals in that spirit.

While we can all agree that we should be prudent, what is meant by that is more controversial. We had a comprehensive review of the adequacy of the Fund's precautionary balances in April, and Table 3 of EBS/94/100 includes various ratios to help us in our judgment. These certainly do not imply that the Fund's precautionary balances are grossly inadequate.

At the same time, it must be remembered that Fund exposure is highly concentrated: for example, over 50 percent of purchases from the General Resources Account outstanding to non-arrears countries are in relation to just five members. This degree of concentration is expected to remain, although some of the members concerned will probably change. Furthermore, recently there has been a preponderance of programs in which it has been clear that the Fund has been taking greater than normal risks; we must recognize the consequences arising from these risks for the appropriate level of precautionary balances. Looking forward, there is also the possibility of increasing average access as a percentage of quota. These factors lead me to conclude that precautionary balances are certainly not excessive, and now is not the time to become less prudent.

Having said that, it must be recognized that there are two aspects of our past behavior which, while prudent, are not generally regarded as being fair and reasonable; these aspects are "double counting" and the asymmetric treatment of excesses and shortfalls relative to net income targets. I am content to see changes in both these practices--namely, less prudence in both respects--provided overall prudence is maintained. The staff proposals do not include a double-counting provision, and they are symmetric with regard to shortfalls and excesses--the decision as to what to do with either at the end of FY 1995 is not prejudged. However, the small shortfall for FY 1994 is not added to the net income target for FY 1995.

The proposed permanent change in contributions to the SCA-2 is a necessary component of any set of decisions if they are to be regarded as fair and reasonable. Further, by agreeing to a ratio for the rate of charge today, we will lay to rest the asymmetry between a variable rate of remuneration and a potentially fixed rate of charge.

The staff proposals do not perpetuate any of the perceived anomalies I referred to in our discussion of burden sharing on April 29. In that light, I think that they are fair and reasonable. They are in some respects less prudent than past practice, but since they maintain the rate of accumulation of precautionary balances, I am content that they are sufficiently prudent overall.

Thus, I support the staff proposals. Of course none of this detracts from the need to press ahead with an examination of alternative systems.

Mr. Smee made the following statement:

Let me say at the outset that I support the proposition to undertake an in-depth review of how we finance the Fund, and I look forward to the staff's, and subsequently the Board's, examination of other mechanisms, such as selling gold and using the investment income to fund the costs of the IMF. I fully recognize the benefits of improving the transparency of the Fund's finances, but we are certainly not in a position to resolve the issue today. Therefore, let us address the immediate issue at hand--setting the rate of charge for FY 1995. And, in doing so, let us set the foundations for a system for FY 1995 and beyond, one that appears both balanced and equitable to creditors and debtors alike.

The staff is to be congratulated for providing us with clear and concise information that facilitates our discussion today. In particular, I note the usefulness of Table 4, which sets out a series of various ratios of reserve cover to outstanding credit. As Directors may recall from our discussions in April, I recommended utilizing the ratios found in line item N, free reserves as a proportion to non-rights credit to non-arrears countries. I still maintain that the SCA-2 should be excluded when judging the adequacy of general precautionary balances but, as the Treasurer noted in our last discussion, we must ensure no double counting.

Looking at line item N, we see that if we accept the staff's recommendations for the rest of this fiscal year, we will basically reach the 3 percent coverage which I advocated. This will enable us to satisfy the two criteria which I set out at that time: to cover 25 percent of the average loans of the 5 largest borrowers or, alternatively, cover about double the average loans of all borrowers, including the 5 largest.

Assuming a settlement of arrears by Zambia and General Resource Account financing of rights of SDR 200 million, the ratio of free reserves to non-rights credit to non-arrears countries would exceed 5 percent, which, in view of the current perceptions of risk, I consider to be more than adequate. In other words, after this fiscal year, I would propose we confine our reserve accumulation to the SDR 1 billion target of the SCA-2, we ensure the 3-1 split, and we no longer add to general reserves or the SCA-1, except for any increase in net credit outstanding at 3 percent. If our assessment of risk should change in the future, we could revise our preferred reserve ratio and determine the time frame over which we would like any adjustments to be made.

Against this background, I support the staff's recommendations for this year--not because I endorse the notion of continuing formula-driven reserve accumulation, which I do not, but rather the recommendations get us where I think we should be by the end of this fiscal year. I would urge Directors to support the formula-driven recommendations one more time, and, it is hoped, one last time.

I would caution against shaving at the margins, simply because, in my view, we are close to meeting our objective of reserve adequacy if we support the staff's recommendations. A formula of 4 + 4, or 3 + 3 percent, or whatever, may provide some short-term gain, but also lengthens the reserve accumulation process, which we all agree is less than satisfactory.

Now, let us put to rest another contentious issue--net income surpluses and shortfalls. I suggest that we include in our decision today that surpluses, or the net of payment of special charges, will be rebated and shortfalls will be recouped, beginning with this fiscal year. Special charges should accrue to the membership as a whole, and as such should be put into reserves. Let us consider payment of special charges as something of a small down payment on possible rising future risk.

Mr. Shaalan made the following statement:

As we have indicated during recent discussions regarding the Fund's precautionary balances, we believe these balances are quite adequate, if not more than adequate. I do not have new arguments in support of this view, and I do not think it would be particularly productive to repeat old ones today. Rather, in the interest of facilitating the discussion, and with the hope of bringing the matter before us to a close today, let me say that I would be willing to support a solution that is based on the following elements: a net income target for FY 1995 of 4 percent of reserves at the beginning of the financial year, a contribution to SCA-1 at an annual rate of 4 percent of reserves at the beginning of the financial year, and an agreement now that any and all excess of net income during FY 1995 will be used retroactively to reduce the rate of charge for the year.

I have listened with interest to your ideas on how to bring the matter before us to a close today, and I would like to assure you that I fully agree with you on the importance of doing so. By seeking to insure that what we regard as a rapid pace of reserve accumulation does not become excessively rapid, your proposal does indeed address an important concern of ours. It does not, however, adequately respond to the concern--shared by a number of us I believe--that the pace of reserve accumulation embodied in the staff's proposals is on the high side. I realize of course that, ultimately, this is a matter of judgment regarding the adequacy of the precautionary balances. I have expressed my view concerning this matter, and I will with interest listen to what my colleagues will have to say. But before that, let me ask the Chairman whether, when he referred to upward adjustment in the rate of charge in the event of a shortfall, he specifically had in mind the rate of charge for FY 1996.

The Chairman said that any shortfall in the Fund's income position should be met by an appropriate increase in the net income target in 1996 and not by a retroactive increase in the rate of charge.

Mr. Geethakrishnan made the following statement:

Before addressing the issues before us at today's meeting, I would like to briefly recapitulate our discussions at our December 13, 1993 meeting, when we reviewed the Fund's income position for FY 1994. Owing to a projected shortfall of SDR 25 million in the net income target of SDR 88 million for that year, the staff had recommended an increase in the proportion of the rate of charge from 111 percent to 117.4 percent. At the meeting, the Treasurer drew attention to the further drop of the SDR rate and pointed out that, as a result, the shortfall could be higher at SDR 32 million, requiring an increase in the coefficient to 119.6 percent.

At the meeting, several Directors, including myself, had argued against the increase in the coefficient. Our argument was simple. If a large shortfall in the net income had been projected, it was not because there had actually been any shortfall in the first six months. In fact, the first six months' net income on an annual basis was higher than the target fixed by SDR 13 million. The reason for alarm lay in the pessimism underlying the assumptions for the projections for the second half of the year. Many of us had questioned this pessimism--we felt that the SDR rate, having gone down substantially during the past period, was more likely to go up than down; and that the possible purchases for the year as a whole had been projected on a very conservative basis. We had pointed out the actual turnout during the second half of the year could therefore be much better than the staff projections.

Some chairs, however, did not agree with this approach. One chair felt "that postponing the increase in coefficient...in addition to being short-sighted...is also unfair to some countries...we urge others to take a cooperative approach to the current decision."

Some chairs suggested a compromise option whereby the coefficient, as proposed by the staff, could be agreed upon, subject to it also being agreed to reduce the coefficient retroactively to the level of surpluses, if any accrued by the end of the year.

Finally, in the absence of the required majority for approving the staff's proposal, the coefficient was retained at the then existing level of 111 percent. The present staff report shows that, contrary to the earlier expectation of the staff, the actual shortfall in income was quite negligible at only SDR 1 million.

I am referring to all this not to say that some of us were better in forecasting, but to point out that, if some of us did not endorse the staff suggestions, it was not because we did not want to cooperate with others, or were taking a shortsighted view. In view of the complex and varied set of factors influencing the final outcome, accurate forecasting is a difficult task. Some of us had genuine reasons for thinking that the outcome could prove better. I am also drawing attention to these issues because once again it appears that the staff projections, in regard to the coefficient to be adopted, have been made in a routine manner and are again based on extremely pessimistic assumptions.

Reserves plus the SCA-1 balances more than fully cover the credit in arrears, and if, by the end of FY 1995, Zambia regularizes its position with the Fund as expected, the coverage would become 200 percent. Even if all present arrears are offset by the precautionary balances, and further, if rights-related credit and balances in the SCA-2 are fenced off, the remaining precautionary balances cover 2.1 percent of nonarrears, nonrights credit. This will increase to about 2.5 percent at the end of the current financial year, and possibly to 5 percent if and when Zambia regularizes its position. We consider it quite prudent that after providing 100 percent cover for high-risk cases, presently we have a cover of over 2 percent for other credit. In fact, now that the high-risk cases have been covered fully, and provided the arrears level is stabilized or is diminishing, the precautionary cover against nonarrears, nonrights credit will increase rapidly. Moreover, in view of the circumstances of the current arrears cases, we are not about to recognize a loss.

Cumulative additions to precautionary balances in the past 10 years were twice as much as the cumulative additions in the 30 years previous to that. During the most recent five-year period, additions to precautionary balances, as a ratio of the increase in balances subject to charges, amounted to 26 percent. Measured against net credit, the proportion is even higher. For this reason, we consider justifiable the view that a modest slowing down of the rate of accumulation of reserves is timely. Doing this through a reduction in the net income target to 3 percent would lower the rate of charge, and at the same time, reduce the burden it has to carry in meeting the nonoperational costs of financing the Fund.

Should Zambia regularize its position with the Fund, the income will get a boost of SDR 45 million. Considering that the 5 percent net income target translates into SDR 85 million, the regularization of its position by Zambia should give a relief of over 2.5 percent in the net income target for the year. Thus, we are talking about a significant change, and not of a change at the periphery. If this is also taken into account, then the net income target could be fixed at less than 1 percent.

As we pointed out in the previous discussion on this issue, the SDR rates have been quite low in the recent past, and will most likely go up during the year. To the extent the SDR rate goes up, the coefficient for the rate of charge will go down. I am not saying that the SDR rate will go up; I am simply drawing attention to the fact that there is a greater chance that it will go up than that it will fall further.

Likewise, the order of purchases projected also appears to have been made on a conservative basis. The ongoing dialogue on the programs in the countries of the former Soviet Union, including Russia and Eastern European countries, definitely points to a larger order of drawings on Fund resources than had been assumed. If this were to happen, the Fund's overhead expenditure would be spread more thinly over a larger base of lendings, which would lead to a reduction in the proportion to be applied on the rate of charge.

Lastly, there is the oft-repeated statement of the Managing Director that possible savings in expenditure this year could lead to savings in budgetary allocations, as had happened in FY 1994. This will also have a favorable impact on the coefficient.

Thus, to sum up, there is a case for a major revision in our approach to the determination of the net income target, and also for fine-tuning the coefficient, bringing it in line with likely trends in the various items that I have discussed. But all this will take time. For the present, I would suggest we agree on a net income target of 4 percent--this rate should apply to additions to the SCA-1 as well; adjust the coefficient for the rate of charge on this basis; and leave it at that with a provision for automatic retroactive reduction to the extent of any and all surpluses.

We have no problems in approving proposed Decision 1.

Extending his remarks, Mr. Geethakrishnan added that symmetry should not be considered from the point of view of the borrowers--a reduction offset by an increase. Symmetry could be achieved automatically the moment the ceiling of 80 basis points was removed.

The Chairman noted that removal of the ceiling would be discussed at a later date. Meanwhile, symmetry could not be perfect, but every effort should be made to build on a good faith arrangement that would not cause excessive improvement or deterioration in a process considered acceptable.

Mr. Sirat made the following statement:

This chair believes there is some sense in reducing the pace of accumulation of our reserves and linking it somehow with the pace of our lending activity, considering that our level of precautionary balances is adequate, as regards our past lending activity, such as the coverage of our existing arrears.

In this context, the question is how to better target our balances to cover our present lending activity.

As an illustration, our net lending activity was this year approximately SDR 900 million.

The staff proposes that we increase our precautionary balances by SDR 278 million, that is more than 30 percent of our net lending this year and 14 percent of our projected lending activity next year. We consider such figures to be rather on the high side.

In the short term, we favor a reduction in the pace of accumulation of reserves. If our existing reserves are to be the reference, we could support reducing the accumulation, for instance, to 4 percent for net income and the SCA-1. Such a reduction should not be considered a definitive one; there is no reason to consider the present 5 percent a taboo not to be changed under any circumstance.

As exemplified in Table 3 of the last staff report, a move to 4 percent would only marginally reduce our ratio of precautionary balances. Indeed, assuming the settlement of Zambia's case, we would move to total precautionary balance available for non-arrears credits, representing 7.6 percent of non-arrears credits, a level we would deem on the safe side. Similarly, with such a target, our total increase on reserves would reach SDR 253 million, only SDR 25 million less than under a 5 percent hypothesis, which represents 28 percent of this year's net lending and 13 percent of the projected lending activity for next year.

I might add that we do not see much sense in keeping the "status quo" for next year, waiting for some revolutionary change in our financing structure. We certainly favor an in-depth discussion on alternative proposals, but such proposals would not by themselves reduce the need to come to an agreement on the appropriate level of our precautionary balances.

This being said, the definition of our target income for FY 1995 is made more difficult by the presumption shared by many that we would benefit from a substantial excess next year.

Whatever the level of our target income, thanks both to a volume effect or higher access limit and to a price effect or higher SDR rate, as well as the possible settlement of Zambia's case, it is very probable we would have an excess.

As you suggested, Mr. Chairman, the possible treatment of this excess should be addressed today. I see two main possibilities here: either to arbitrarily decide to compensate both shortfall and excess, whatever their origin; or to differentiate according to the origin of the shortfall or excess.

I made suggestions in this regard at our last meeting, suggesting differentiation, within our income, of the volume and price effect. Obviously, this proposal still needs some elaboration and technical study by the staff before any further discussion. In the meantime, we could accept the principle of a retroactive change in the rate of charge to fully compensate for any excess or shortfall next year.

Finally, we support Decision 1, placing net income for FY 1994 into the Fund's Special Reserve.

Mr. Marino made the following statement:

Again, today we have to make decisions revolving around three main issues which are largely judgmental: the adequacy of the Fund's precautionary balances, the risks undertaken by the Fund in its future lending policy, the equity of cost distribution of accumulating precautionary balances among the institution's members. We consider that, as a general principle, the amount of precautionary balances the Fund accumulates cannot be separated from the manner in which such accumulation is financed. Unfortunately, under the current system, this is not the case. Therefore, we welcome the examination of the issue again in the near future.

From Mr. Dorrington's statement, and previous speakers, we see that there are still different perceptions as to the adequate amount of precautionary balances that the Fund should hold. Fortunately, we also see an important consensus being reached today: that a decision should be fair, reasonable, and prudent.

Let me briefly go over two indicators: in the last ten years, total outstanding credit has fallen by about SDR 9 billion, while the total of precautionary balances has almost tripled, increasing from 1,043.9 to 2,847.2 million SDRs. At present, reserves plus the SCA-1 represent 128 percent of credit to members in arrears. If we accept the staff proposal, this coefficient could well reach 206 percent if Zambia settles its arrears, or 138 percent if there is no progress in arrears cases.

But these are not the most important aspects. First, the Fund has developed a coherent framework to prevent, deter, and apply remedial measures, that has had considerable success in containing the arrears problem, including the Third Amendment to the Articles of Agreement. Second, the Fund relies on strong adjustment programs to ensure that users of Fund credit will attain external viability. We have already seen a number of successful cases that, through the Fund's involvement, have regained their external viability. Third, the Fund conducts an explicit evaluation of a member's capacity to repay the Fund and, thus far, I have never seen doubts expressed as to the member's capacity to repay the Fund. Finally, the Fund has a preferred creditor status, and member countries are well aware of the consequences within the international financial community of being in arrears to the Fund. In addition to all this, we have had a quota increase that considerably improved the liquidity of the institution, and we also have hidden reserves: the Fund's gold holdings which, at the current market value, exceed total credit outstanding of the institution.

With all these indicators and policies, it is difficult to advocate the continuation of the fast pace of reserve accumulation that we have had during the last ten years, since reserves are more than adequate at current levels.

This leads me to conclude that the proposed target amount of net income for FY 95 of 5 percent of the Fund's reserves and the amount proposed for accumulation in the SCA-1 is excessive.

Our preference would be for a much lower pace of reserve accumulation. However, recognizing that we have to be fair, reasonable, and prudent, I could go along with the proposal for a very modest reduction in the rate of reserve accumulation, to 4 percent, and a reduction in the rate of increase of SCA-1, to 4 percent. This would be acceptable only with the explicit agreement to apply any excess net income in FY 1995 to a retroactive reduction in the rate of charge. We could agree to this merely symbolic reduction in the rate of reserve accumulation, taking into account the difficulties of reaching the required 70 percent majority. However, we would need the commitment by the Board, the staff, and management to revisit the substantive issue of the cost distribution of operating the Fund before the Board recess. We have to move away from the comforts of the status quo, toward equitable and self-sustaining methods.

The Chairman observed that Mr. Marino supported part of his compromise, and he wondered whether the overall package might not be acceptable.

Mr. Marino stated that the Chairman's proposal appeared to be the initial position rather than a compromise.

Ms. Srejber made the following statement:

This chair has traditionally put considerable emphasis on adequately safeguarding the Fund, both through appropriate conditionality and through the buildup of satisfactory precautionary balances. When we last met on this subject, we indicated that the proposals by the staff, viewed as a whole, resulted in a reasonable coverage of the financial risks to which the Fund is exposed. Staff proposals also showed a reasonably equitable distribution of the costs, bearing in mind that before long we will embark on the much-needed broad review of the income-generating mechanisms of the Fund. We continue to hold these views. We broadly agree with the case set out in the staff's proposals. However, while finding the proposals acceptable, we added at our last meeting that we would be willing to consider alternative packages for FY 1995 that gave a similar level of risk protection to the Fund.

In my view, the proposals put forward to reduce the income target to 4 percent are inconsistent with our aim of maintaining the level of protection for the Fund. It is not really a repackaging; it is taking something away without adding anything. We feel that with the uncertainties of the present and foreseeable future, the Fund's reserves are not excessively high.

We also have to be aware that, if we cannot reach an agreement with a sufficient majority, certain automatic mechanisms will start operating. I am not comfortable with the results these mechanisms would produce, neither on the general level of the Fund's reserves or distribution between the various reserve categories, nor on the distribution of the costs of operating the Fund. I doubt others would be either. This should, of course, give us all a strong incentive to try and make the necessary decisions today. This chair is certainly willing to consider some repackaging of the various elements, but only as long as we feel that this would not compromise the Fund's need for adequate reserves against the risks it is facing.

Mrs. Wagenhoefer stated that she could support all staff proposals. As might be recalled, her authorities attached great importance to the maintenance of a net income target of 5 percent of reserves. Her chair had long held the position that the Fund's total reserves should be steadily increased until precautionary balances had reached a level which sufficiently covered all risks of the Fund. The staff had rightly pointed out that the Fund would remain exposed to substantial risks in the future, in view of the projected expansion of Fund credit to members that faced especially difficult economic and financial problems.

Against that background, Mrs. Wagenhoefer continued, she concurred with the staff that it would be premature to reduce the Fund's planned addition to precautionary balances at the present time. Regarding the suggestion to take a decision at the present meeting about what would be happening to a surplus or a shortfall regarding the income target, she noted that her chair's position had always been that such a decision could logically only be taken at the end of the financial year, when the actual level of Fund's net income and its sources were known. That would also have the advantage that the Board could take into account the outcome of ongoing discussions on the adequacy of the Fund's precautionary balances. If the majority were to follow the Chairman's compromise proposal, which rate would then become the new rate of charge for the financial year 1996? Would supporters be prejudging the rate of charge of the following fiscal year by announcing such a decision at the current meeting? How could the Board make sure that the rate of charge to be decided upon for 1996 would be adequate to meet the income target that would be proposed?

Mr. Cippa made the following statement:

> Summarizing the changes in the accounting system, the net income for FY 1994 is only SDR 1 million short of the targeted SDR 88 million. Because of this small difference, I do not see any need to recapture it in the income target for FY 1995. I support Decision 1, to place the actual net income of SDR 76 million to the Fund's special reserve.
>
> With respect to precautionary balances, I acknowledge that their level now exceeds the credit outstanding to members in arrears. However, we do not consider it appropriate to associate the provisioning only against risks that have already materialized. I have more sympathy for an approach in terms of the risk characteristic of the whole Fund's portfolio, and I look forward to more operational proposals in this respect. I agree with Mr. Dorrington that this is not the time to become less prudent. I am particularly convinced by arguments regarding the concentration of the Fund's exposure, the high risks attached in some recent Fund programs, and the likelihood of some changes in the access policy. I therefore endorse Decision 2, to set the net income target for FY 1995 equivalent to 5 percent of the reserves at the beginning of the year, and accordingly, to fix the

coefficient for the rate of charge at 115.1 percent of the SDR interest rate.

In the event our estimates or assumptions prove wrong, we will be willing to consider, along with a shortfall catch-up provision, the proposal to reduce retroactively the rate of charge, if actual net income exceeds the target.

In the absence of any better alternative, this chair supports a continuation of the burden sharing mechanism for the remainder of the financial year, in line with Decision 3. This would automatically provide a debtor's contribution to the SCA-2, with the 1:3 intended ratio between the shares of debtor and creditor countries, and leave the additional adjustment to the rate of charge at 4 basis points.

Mr. Al-Tuwaijri made the following statement:

In reviewing the adequacy of reserves, it is only natural to take into account the level of overdue obligations to the Fund as well as the need for protection against potential overdues.

It is clear that the Fund's reserves are more than adequate protection against overdue obligations. This is evident from the increase in precautionary balances to more than 160 percent of member's credit in protracted arrears by end-FY 1994. Coupled with the relative success of the cooperative strategy, this argues for a slowdown in the rate of reserve accumulation.

On the other hand, it is also clear that the Fund's risk exposure is increasing, for the reasons detailed in the staff paper. While I still believe that the Fund's best protection against future arrears is strengthened conditionality, prudence is also called for in reserve accumulations. In this regard, any increase in access limits, without stronger conditionality, would necessarily increase the need for reserve accumulation.

Therefore, I believe that the proposed net income target for 1995 is reasonable. If consensus is attainable, however, I have no difficulty in supporting a somewhat lower target. Here I would like to note that once we agree on a net income target, we should stick to it in a symmetric way. This means excesses should be retroactively reimbursed, and shortfalls should be recaptured in the following period.

I also support the staff's proposed burden sharing decision.

Mr. Prader made the following statement:

This chair can join the consensus on the proposed decisions for the disposition of the net income for FY 1994, and for setting the net income target for FY 1995 at 5 percent and rate of charge at 115.1 percent. We also endorse the continuation of burden sharing for deferred charges and contributions to the SCA-1 for the remainder of the financial year, at an annual rate of 5 percent of the reserves at the beginning of the financial year. We accept that the adoption of Decision 3 would imply that the rate of charge adjustment to finance the debtors' contribution to the SCA-2 would continue at an annual rate of 0.04 percent. I can also endorse the Chairman's compromise proposal to return any excess income at the end of FY 1995 to the borrowing countries, in the form of a retroactive lowering of the rate of charge.

Our support for these decisions is based on our view that, in view of the unique character of the Fund, the Fund's reserving policy should avoid any direct linkage between a particular degree of risks and a particular level of reserves. This is why we favor a fixed rate of reserve accumulation rather than a policy of discretionary changes in reserves based on an ad hoc assessment of risks.

It is true that the proposed additions to the Fund's reserves, at the rate of 5 percent to general resources and the SCA-1, represent a very cautious approach, particularly taking into account the progress made on the arrears front. However, it seems prudent to continue our cautious approach by maintaining a significant fixed percentage of reserve build-up, both in order to safeguard the Fund, and also to distinguish the Fund's reserve procedures from the commercial banks' provisioning practices.

Nevertheless, our chair will be prepared to see the present 5 percent rate of addition to reserves lowered later on, once it becomes sufficiently clear that the Fund's policy for dealing with arrears--essentially a rescheduling of Fund loans--has worked not only in a technical, but also in an economic, sense.

Mr. Hon made the following statement:

At the outset I would like to reiterate the observation made earlier by this chair that the Fund's precautionary balances are more than adequate to deal with any reasonably identifiable contingencies. This comfortable situation was mainly brought about by the establishment of the SCA-1 in 1987 to deal with the deteriorating situation in overdue financial obligations, and the setting-up of the SCA-2 in 1990 in conjunction with the initiation of the rights approach. Since 1987, the precautionary balances have been accumulating at a compound annual rate of more than

10 percent. With the progress made in the strengthened arrear strategy and the diminishing need for rights accumulation programs, the rationale for an extremely high rate of accumulation is no longer valid. Furthermore, the use of Fund's credit has stabilized in the recent past, and has been growing only moderately in the last two years, as the Fund began to offer financial assistance to new member countries. There is, therefore, ample room for a sizable reduction in the rate of accumulation of precautionary balances.

On the other hand, I agree with the staff that the Fund has recently been taking greater than normal risks in some of the new programs. I believe, however, the precautionary balances remain adequate, even taking into account the potential credit exposures embedded in those programs. If this trend of more risky lending continues and concentrates in countries with similar problems and difficulties, I have to agree that the precautionary balances should continue be accumulated at a reasonable rate not much slower than the present pace. I can, therefore, go along with Mr. Shaalan's proposals.

Mr. Lanciotti considered that the staff documents offered a satisfactory answer to several points raised by the Board during the April 29 meeting. The review of the Fund's income position was certainly the most appropriate occasion for considering the related issue of precautionary balances in a general framework. It was his impression that the decisions proposed by the staff improved the quality of the policy guidelines, which the Board was considering under the three different criteria listed by Mr. Dorrington in his statement. Therefore, he had no difficulty endorsing the staff proposals, and would only add some remarks concerning the criterion of prudence.

While agreeing that the proposals were sufficiently prudent overall, considering the near future, he would remind his colleagues that the Fund was facing the challenging task of increasing its ability to provide financial support to many member countries, among which the economies in transition were the most striking, Mr. Lanciotti continued. Such an effort, by increasing the risk for the Fund, would require in years to come a larger risk coverage in order to prevent an undesirable reduction of the ratio between precautionary balances and the total credit underlying any increased access policy. Indeed, such reduction could ultimately induce the Fund to adopt a more prudent attitude in considering member countries' requests for financial assistance, thereby creating a bottleneck which would offset the positive effects of a larger availability of resources. Further efforts in elaborating new solutions to face the risk associated with the changing and challenging environment would probably be needed, and they were likely to require a broad consideration of the whole matter.

Mr. Wei made the following statement:

I would like to summarize this chair's views as follows: first, on the disposal of the actual net income for FY 1994, we can endorse the staff's proposal to place SDR 74 million to the Fund's Special Reserve. We also agree with the staff that owing to the relatively small shortfall of the actual net income, only $1 million, it is not necessary to make up this shortfall in FY 1995.

Second, the Fund's precautionary account has increased to the extent that, in our view, it is adequate to protect our institution from incurring possible risks. According to Table 3 of EBS/94/100, the total amount of credit to members in arrears and credit covered by the SCA-2 is SDR 2.35 billion; however, the precautionary balances are SDR 28.6 billion, about SDR 500 million more than the risks the Fund is faced with.

Also, considering that Zambia is expected to settle its overdue obligations and the GRA financing rights of SDR 200 million, the Fund's precautionary balances will be in an even more comfortable position. In order to facilitate the developing countries who are undergoing a difficult adjustment process, I support the proposal that the target amount of net income for FY 1995 and the amount for the SCA-1 be reduced to 4 percent of the Fund's reserves, respectively; the actual net income for FY 1995 should be used retroactively to reduce the rate of charge; and the rate of charge should be adjusted accordingly. However, if this proposal does not receive sufficient votes, in the spirit of cooperation, I can go along with the Chairman's compromise proposal.

Mr. Mwananshiku made the following statement:

We are pleased to note that the actual net income for FY 1994 is close to the target amount of income for that year. This outcome has helped avoid sharp upward adjustments in the rate of charge for FY 1995, which would have been necessary had the shortfall to be taken into account in determining the target net income for FY 1995 been much larger. The shortfall of SDR 1 million is indeed relatively small, and we support the staff proposal that it should not be taken into consideration when determining the target net income for FY 1995. We support the placing of the net income for FY 1994 into the Fund's Special Reserve, as proposed by the staff.

However, we find it difficult to accept the proposed coefficient for the rate of charge for FY 1995. The resulting rate of charge, 4.77 percent, would be 28 basis points higher than the average for the fourth quarter, ending April 30, 1994, and would increase the burden on debtor members by reversing the welcome development of FY 1994, which was otherwise characterized by continuous decline in the rate of charge. We would have liked to see a rate of charge that did not raise the burden further, but rather kept it below that of FY 1994.

As is well known, the total amount of credit outstanding to members in protracted arrears is now more than fully covered by the precautionary balances already accumulated. Moreover, protracted arrears have been reduced from their peak at end-1992. The Fund has also at its disposal useful safeguards against the emergence of new cases of large arrears, as was seen during the mid-1980s to 1992. The catalytic role of the Fund in facilitating the provision of both debt relief and additional financing to its members, the high weight the Fund attaches to the quality of adjustment programs, the mechanism 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 preventive and deterrent measures. Moreover, the present policy of reviewing regularly the levels of income and precautionary balances provides the Board an opportunity to respond quickly to circumstances as they arise.

In the light of all these developments, and taking into account the fact that recent rates of reserve accumulation have been very high by historical standards, I feel that a slower pace in FY 1995 is warranted. Accordingly, like several other speakers, I would like to see the target amount of net income added to reserves and the amount added to the SCA-1 each to be reduced to 4 percent of reserves at the beginning of the year. Moreover, in the event that actual net income exceeds the target amount for the year, I support a retroactive reduction of the rate of charge through a refund to those who bore the burden.

I am of course not unmindful of the risks associated with the recent expansion in Fund lending. I would for this reason suggest that if new arrears emerge and become protracted, we would be prepared to support a resumption of an accelerated pace of reserve accumulation.

Finally, I support the continuation of burden sharing for deferred charges and contributions to the SCA-1 beyond the first quarter of FY 1995.

Mr. Daïri made the following statement:

The issues of Fund's income, precautionary balances, burden sharing, and the cost of Fund resources have been extensively debated by the Board during the last two years. During the same period, the collaborative strategy to deal with countries in arrears to the Fund has been successfully implemented, leading to a reduction in both the number of countries in arrears and in the total stock of overdue obligations. In addition, the Fund is now rightly implementing a budget consolidation following the large increase in membership and activities. This chair has consistently supported the Fund in the design and implementation of the above-mentioned policies, and we feel that we are now entitled to capitalize on the success of these policies through a reduction in the rate of charge, which could be achieved by easing the accumulation of precautionary balances by the Fund.

Like many other Directors, we had the opportunity to point out the comfortable level reached by precautionary balances; the staff report confirms this finding. Between 1987 and 1994, and following the increase in the net income target from 3 percent to 5 percent of reserves, the creation of the SCA-1 and the SCA-2, precautionary balances increased by 131 percent. During the same period, overdue obligations decreased by 25 percent, and total credit outstanding fell by 19 percent. The improvement in precautionary balances is more dramatic if assessed against outstanding credits and arrears. For example, between 1987 and 1994, the ratio of precautionary balances to total credits jumped from 3.9 percent to 11.2 percent. Similarly, the ratio of reserves and SCA-1 to outstanding arrears increased from 53.3 percent to 128.1 percent. The level of precautionary balances and the appreciation of their relative importance could further be enhanced if we add to them the shortfall in creditors, contribution to the SCA-2, which amounts to SDR 220 million.

If we combine the sizable improvement in precautionary balances with the recognition of the Fund's preferred creditor status, the success of the arrears strategy, the quality of Fund programs so far, and the highly undervalued assets held by the Fund, referred to by the staff, we must conclude that the current level of precautionary balances is more than adequate and the level of annual accumulation is extremely high.

For these reasons, and taking into consideration the expected settlement of Zambia's overdue obligations in FY 1995, we can support the addition of net income for FY 1994 to the Fund's Special Reserve.

We urge the Board to adopt a net income target for FY 1995, below the proposed 5 percent of reserves, at the beginning of the year. Our preference is for a target net income of 4 percent of reserves at the beginning of the year. We would also like the staff to comment on the idea of fixing the net income target, not by reference to reserves at the beginning of the year, but using other alternative indicators, for example, the annual average level of reserves or the level of outstanding credits. In all cases, we reiterate our long-standing view that any excess in net income compared to the target amount should be used to retroactively reduce the rate of charge.

We support the continuation of burden sharing for deferred charges and contribution to the SCA-1, but at an annual rate of 4 percent of reserves at the beginning of the year.

We support the continuation of debtors contribution to the SCA-2 at an annual rate of 0.04 percent. We note in this regard, that a net income target below 5 percent will allow a greater recovery of the shortfall in creditors' contributions to the SCA-2. While on this subject, we would like the staff to elaborate on the impact of the shortfall in the SCA-2 on the Fund's income position.

Mr. Verjbitski made the following statement:

On a number of occasions in April and May, this chair reiterated its strong support for reducing the unnecessarily rapid pace of accumulation of the Fund's precautionary balances. The desirability of sustaining a high net income target rate--which now exceeds the SDR interest rate--is, indeed, questionable, particularly at a time when all quantifiable credit risks have been covered by the Fund's reserves with a comfortable cushion, and the Fund's liquidity position remains solid.

I agree with Mr. Dorrington that table 3 of EBS/94/100 is helpful in facilitating our judgment on the adequacy of the Fund's current reserves. Total reserves--including balances in the two Special Contingent Accounts--stand presently at SDR 2.8 billion, which is twice the amount of the repurchases that have been overdue for more than three years. Table 2 of Supplement 1 to EBS/94/100 provides further evidence that, even if a reduction of the net income target as a percentage of the Fund's reserves at the beginning of the year is effected now, these reserves would still grow in FY 1995 by some SDR 227.9 million under a 3 percent target rate, or by some SDR 253.0 million under a 4 percent target rate. Importantly, these staff projections still may appear quite conservative, as they do not take into account the successful completion of the rights accumulation program by Zambia, expected in FY 1995, and the resulting addition of an extra SDR 45 million to the Fund's precautionary balances. Thus, establishing a 3 percent net income target rate for FY 1995 could be regarded as more than adequate.

However, at this time I can fully support the moderate compromise proposed by Mr. Shaalan and many other speakers on setting the Fund's net income target rate for FY 1995 at 4 percent, and using this rate for reserves' accumulation in the SCA-1.

Accordingly, Decisions 2 and 3, proposed by the staff, need to be amended to reflect this lower rate. It is noteworthy that a better contribution ratio to the SCA-2 would be achieved, inter alia, through a lowering of the annual income target, as, under the staff projections, it will allow recovery of about SDR 9 million of shortfalls in creditors' contributions. I can certainly go along with maintaining the respective adjustment to the rate of charge, at the level of 4 basis points, and permanently abolishing the "double counting" provision and other asymmetries.

Finally, apart from our discussion today, we shall be prepared to consider, in due course, a broader spectrum of improvements in distributing the financial costs of operating the Fund among the membership, including the proposals to establish a uniform norm of remuneration.

With these comments, I support the proposed decisions with the suggested amendments.

Mr. Zoccali made the following statement:

At the outset, I would like to welcome your announcement that the comprehensive discussion of the cost of financing the Fund and its distribution among the membership will be held before the Board recess. We trust that the paper that will serve as the basis for that discussion will examine in detail the implications, inter alia, of Mr. Posthumus' proposal of a uniform norm for remuneration to recover administrative expenses and accumulate further precautionary balances, its country-specific impact, and the steps required for its implementation as well as possible modalities for mobilizing part of the Fund's gold holdings to generate income. We believe that progress toward a more equitable distribution of the Fund's financing costs, namely, one that better reflects members' quotas, is essential to facilitate consensus on issues central to preserving the Fund's financial integrity.

We are pleased that actual net income for FY 1994 was very close to the original target, despite an estimated SDR 11 million shortfall some weeks earlier. When proposals to adjust the rate of charge at midyear are advanced, the staff's caution in estimating net income needs to be kept in mind. This said, we can agree to the staff's proposal regarding the disposition of actual net income for FY 1994, of SDR 74 million to the Fund's Special Reserve.

Before addressing the target amount of net income and the coefficient for the rate of charge for FY 1995, a brief comment is in order regarding the current level of the Fund's precautionary balances. As stated during our recent discussion on the subject, we consider their present level more than adequate to deal with reasonably identified contingencies, both in relation to the obligations of all the members in protracted arrears and in total outstanding credit. Taken together with the Fund's hidden reserves and the unique nature of its policies on conditionality, we see no reason to continue accumulating reserves at the present rate, as it not only masks a compounding effect, but also falls unduly on users of Fund resources.

Not insensitive to the future demand for conditional resources linked to unprecedented processes of economic transformation, we could support the proposal advanced by Mr. Shaalan. Namely, to establish a coefficient for the rate of charge to achieve a 4 percent net income target for FY 1995, with any excess applied retroactively to reducing the rate of charge; to extend the mechanism of burden sharing for deferred charges and contributions to the SCA-1 for the remainder of the financial year, at an annual rate of 4 percent of the reserves at the beginning of the financial year; and finally, to maintain the current adjustment to a rate of charge of 4 basis points to finance debtors' contributions to the SCA-2, until the SDR 250 million limit is reached.

Mr. Newman made the following statement:

As we have stated previously, we view today's discussion as a precursor to a more fundamental discussion of the current system, by which the Fund finances its operational costs, administrative expenses, and precautionary balances. A number of chairs have expressed dissatisfaction with different aspects of the current system and strong willingness to consider a comprehensive overhaul of this system.

Today's discussion should facilitate, not impede, our efforts in this regard. Thus, rather than take up possible changes on an individual basis--which will only further complicate efforts to develop a more transparent, simple, and equitable financing structure--we should consider the range of possible changes together as part of an overall package. Piecemeal changes are what have contributed to dissatisfaction with the current system and should be avoided as we begin to look at more lasting solutions. Moreover, we should not seek to prejudge the outcome of any comprehensive package of changes.

From this perspective, the staff's proposed decisions are broadly acceptable to us. They address the anomalies, and in maintaining the status quo regarding the net income target and contribution to the SCA-1, preserve the basis for considering more comprehensive changes.

The staff paper, appropriately, does not address the future disposition of possible surpluses or shortfalls in net income. Our strong preference has been to address such eventualities when they arise, and this remains our preference. Nonetheless, we are willing to be pragmatic in the discussion of this issue within certain parameters. Any presumption of a rebate of charges for a surplus, for example, should be matched by an equal presumption that any deficit would similarly be made up. The Fund has failed to meet its net income target for two years now; last year's shortfall was minor, but the recent pattern is not one that should continue. Symmetry should be preserved.

There is the additional issue of the nature of the surplus. In particular, there has long been disagreement in the Board about the disposition of surpluses accounted for by the payment of special charges. We have long held that as the costs of burden sharing are accrued by creditor and debtor alike, the income derived from payment of special charges--which encompass those costs to the Fund directly associated with the accumulation of arrears--ought to be placed in reserves. We recognize that creditors cannot share in any redistribution of such surpluses, but that hardly justifies a rebate--either retroactively or prospectively--to debtors alone. Rather, the surplus should be placed in reserves--as was done in FY 1992--where it might contribute to a sounder reserve position and, in turn, improve prospects for an adjustment in the level of contributions to precautionary balances.

The larger issue involves efforts to move beyond the patchwork system of rules and decisions, to a system that is not a source of recurrent tension. We look forward to early distribution of the staff paper that explores in some detail the Posthumus proposal for an adjustable uniform norm. In addition to laying out the workings of such a proposal, some of the key questions which need to be addressed include the following: what are the implications of the different possibilities regarding the scope of activities to be covered by a uniform norm (for example, administrative expenses, deferred charges, and increases in precautionary balances)? Alternatives or supplements for generating some of these funding needs, such as through a risk premium on charges and/or a possible mobilization of some Fund gold, should also be explored. What will be the impact on individual member countries of the proposal? How, for example, might countries which have drawn down their reserve position reconstitute their unremunerated position?

The legal implications will also need to be described at least generally--both regarding possible amendments to the Articles, as well as questions involving the treatment of precautionary balances.

> As we see it, our efforts in pursuing a change in the current system for financing Fund activities should be guided by the following objectives: simplifying the link between operational income and costs, so that remuneration and charges are more transparently and directly linked to the SDR rate; simplifying the current system of burden sharing in a manner that consolidates precautionary balance accounts and arrives at a more systematic means for assessing the appropriate level of reserves; and establishing a straightforward and transparent system for financing administrative expenses, as well as precautionary balances, in an equitable manner.

Mr. Posthumus noted that, in the statement with which the Chairman opened the discussion, it had been suggested that the system of burden sharing has served the Fund well. If so, it had not been easy. And the Board had held continuing discussions about the burdens themselves and about the distribution of the burdens and about the fairness of the system. And perhaps the Fund should have considered the matter much earlier than it was now going to do. Apart from the fact that he would have hoped for such an admission in the statement, he could support the statement.

The first reason for keeping the 5 percent target was that the Board was faced with proposals to increase access to the resources of the Fund, Mr. Posthumus continued. He was not sure whether central bankers, who after all supplied the Fund with its reserves, would understand the mixed signals involved in increasing access to the resources of the Fund while simultaneously building up reserves even further.

Another point that should not be forgotten was that when one talked about 7 basis points, there was also a reduction of basis points from 26 to 4 in the framework of the SCA-2 operation, and that, at the moment, the SDR rate was at its lowest level in a long time, Mr. Posthumus noted. Those two arguments might help convince others, led by Mr. Shaalan, to perhaps reconsider their position and support the Chairman's total package.

The Chairman commented that he was in agreement with almost everything Mr. Posthumus had said, especially the suggestion that burden sharing had served the Fund well, but at a great loss of time for the Executive Board, which had had to return so many times for protracted discussion of the matter. He also agreed that all those who would call for more risks and increasing access should know that the Fund would not do those things without a proper increase in the reserve position. Mr. Verjbitski, in particular, should perhaps note that there was a contradiction in telling the Fund to go to 3 percent reserve accumulation, for instance, and to tell the Fund to increase access limits to the Fund's resources. That was just impossible. In light of increased risks, the Board must manage the institution in a prudent, conservative way.

Mr. Fayyad said that, while he took the point made by Mr. Posthumus, it could not be said that the Fund was starting with no cushion. In fact, the cushion at present was in excess of total credit extended to members in protracted arrears, with a ratio equivalent to 130. As mentioned by Mr. Marino, if one continued with the rate proposed by the staff, then that ratio would be in excess of 200. That was not exactly starting with no cushion whatsoever.

It was part of the highly specialized nature of the institution that losses were not recognized before the unfortunate event of compulsory withdrawal, Mr. Fayyad continued. It was a most extraordinary event, together with the various arguments made about conditionality being the most important safeguard that the Fund had, whether in connection with access at the levels at which the Fund conducted its business, or in connection with possibly some changed access limits in the future. All that would suggest to him, and that was the basis for the position that his chair had taken, that it might well be the case that there was, indeed, good reason to think that the time was not wrong for rethinking the 5 percent targets.

Mr. Marino said that, if it was recognized that there had been progress in handling the arrears strategy, then the best one could do would be to reduce the rate of accumulation of the protection against arrears. Otherwise, the Fund would be sending the signal that it continued to have a very big problem.

On the issue of the reduction of the 26 basis points, Mr. Marino noted that that had been an integral part of the decision that had been taken when the Board had agreed to the SCA-2, so he could not accept that that was something that was being negotiated or thrown into the consensus, because that was something that had been agreed to from the establishment of the SCA-2.

On the new risks and increased access, his chair had observed that as much as he would like the institution on occasion to take more risks to provide more access, he could not accept that the burden of those risks should fall primarily on the users of Fund credit, Mr. Marino continued. So if the decisions were going to be decisions of the whole institution, Fund members would have to share equitably the consequences of taking those risks and increasing access policy. And the system in place was not conducive to such sharing. This was his preoccupation, not the policy itself.

Mr. Posthumus, commenting on the issue of the basis points, recalled that when the decision had been taken, it had been taken for five years, during which time reserves were to have been built up. It had been recognized at the time that full implementation might not be possible, given the floor in the rate of remuneration. In that context, it had been understood as part of the package that the decision might not be implemented or perhaps not implemented on time. He had only been attempting to say that the total rate of charge was certainly lower than it had been for some time.

Mr. Verjbitski commented that his chair saw no direct automatic link between the access limits and the level of precautionary balances, because in the past it had proved to be that changes in lending by the Fund had not been directly linked to the changes in access limits.

The Chairman said that, because the Fund was a traditional, conservative institution, Directors should not call for a simultaneous increase in access and reduction in reserves. A choice had to be made.

Mr. Verjbitski stated that he could support a 4 percent increase in reserves next year, which could in fact be higher, in view of the likelihood of Zambia's successful graduation from a rights accumulation program.

Mr. Newman observed that one really could not separate the issues of how one financed precautionary balances in the Fund's operational and administrative expenses without also deciding how much was going to be financed. One could not decide the shares unless one also knew the magnitudes. Therefore, the appropriate time for the discussion of precautionary balances and their adequacy was in the context of the subsequent discussion that the Board would have. Also, he would suggest, in that context, that the Chairman's proposal would provide much more immediate relief to debtors through the return of potential surplus than would the reduction in the reserves accumulation to 4 percent, which, as had been noted, resulted in only 7 basis points. Getting both was highly unlikely, in view of the majority that would be required, and he urged his colleagues among the debtors, with whom he shared many concerns about the financing, to take the money and run.

Mr. Geethakrishnan observed that he looked forward to the discussion on precautionary balances. Meanwhile, the present level of 100 percent cover for high-risk cases and 2 percent for nonrisk cases seemed high, prima facie. His suggestion did not go against the integrity of the Fund, but was a logical conclusion that the precautionary balances were reasonably good.

Mr. Newman said that, in the current discussion, all sides had an opportunity, in effect, to block a decision. The result of blocking a decision at the present time would have no effect on the rate of charge. It was either going to be 5, 16 if the Board took the decisions that the staff proposed; if no decision was taken, it would be 5, 15. So if voting power among different groups was employed to achieve a stalemate, nobody would be better off or worse off. Under the Chairman's proposal, debtors would be substantially better off potentially, because the effective rate of charge would be substantially below what would occur with either the staff's original proposals or with a standoff.

Mr. Koissy said that he supported Mr. Marino and the proposal put forward by Mr. Shaalan.

Miss Chang Fong said that she could support the first decision. She would only note that the change in the accounting treatment was going to be a future cost in the administrative charges and a future cost that would be borne by debtors in the calculation of the basic rate of charge in future years.

On the other decisions, Miss Chang Fong continued, she supported the position taken by Mr. Shaalan to reduce the contributions to the reserves and to the SCA-1 to 4 percent each. She did not think that such an approach would, in fact, threaten the Fund's prudential stance. The arguments had been well presented by others, but she would emphasize that the point that she was supporting concerned the pace of accumulation. The precautionary balances in toto and in its separate categories were sufficient to deal with the current exposure envisaged by the Fund. Additionally, if increased access and riskier credits were going to materialize in the future, those should be addressed in a context where there was a more equitable distribution of the financing of the risks. She warmly echoed Mr. Marino's point in that context.

If a compromise were needed, she would suggest that the SCA-1 was, in fact, the preferred vehicle for dealing with provisioning, Miss Chang Fong said. Finally, with respect to how one dealt with surplus income, she would like to emphasize a technical problem with which the debtors were confronted: the practice of increasing reserves by surplus income escalated the burden on the borrowing members, because, first, they were not given the benefit of the rebate, and, second, they were required to make additional contributions by way of the same net income target in the following year because the reserves had, in fact, increased by the surplus income. So, in fact, there was a double contribution that was being made by the borrowing members. She fully supported the suggested method of rebating surplus income to the debtor countries.

Mr. Fukuyama observed that he had thus far been silent, as he had already expressed his view on the matters under discussion at the informal Board meeting two weeks earlier. Naturally, his colleagues could count him as a supporter of the full set of decisions proposed by the staff. On the treatment of excess or shortfall mentioned by the Chairman, he joined Mrs. Wagenhoefer in suggesting that the Board consider the method later.

Mr. Waterman commented that there seemed to be a fairly general agreement that reserves at the moment were rather comfortable, or very comfortable, in view of the existing state of the balance sheet. Prospects were good that the risk associated with the balance sheet would expand in coming years, but there was an issue as to who should bear the additional cost if it was felt that further provisioning of reserves was required to match the increased risks. For his part, he accepted the case for a lower rate of accumulation that was being made by Mr. Shaalan and others; but he also placed great weight on reaching a decision at the current meeting. Therefore, he could accept the compromise proposal initially outlined by the Chairman.

The Treasurer noted that Mrs. Wagenhoefer had asked, if the charges coefficient had to be reduced at the beginning of FY 1996 because a refund had to be made, which of the two coefficients would apply. The unstated assumption was that there would be no agreement on a new coefficient for 1996. In that event, the lower coefficient would carry over under the new system of fixing the rate of charge. And if it were to differ from the staff's recommendation of the coefficient needed to achieve the net income target that the Board would agree in 1996, then there was a fair chance it would not meet its stated objective. But it would be the lower of the two coefficients that would carry on, just as it was the lower of the two rates of charge that had previously carried on. It presumed no agreement on a coefficient. And in light of the Chairman's statement and comments by the Directors, the feeling of goodwill and good faith should carry over in fixing a new coefficient with the suggested package on refunds and shortfalls that had been suggested.

A question had been raised by Mr. Daïri about whether the reserves target could be fixed in terms of either the total level of credit outstanding or, more particularly, on an incremental basis on changes in credit, the Treasurer continued. Directors would recall that the rather unusual system for fixing the rate of reserve accumulation had been established prior to the onset of arrears in the Fund. Like so many other things, it was the arrears issue which changed the Fund's culture. The initial idea of accumulating reserves had not been for prudential reasons relating to arrears. Indeed, in 1981, the idea of arrears had been almost unthinkable. Basically, the reason for introducing a reserve policy for the Fund at the time had been to save the Fund from income shortfalls stemming mainly from administrative and operational expenditures. Therefore, there had been no need to develop a large-scale reserve policy. For various reasons, particularly the flood of arrears in the mid-1980s, the system had been kept in place and the rate of reserve accumulation had increased. It was now felt that it was time to change the system, and the question was how. Tying reserves accumulation to credit outstanding was a system, but it was as arbitrary as the system in place. It required agreeing on some percentage, whether 2, 3, or 5 percent. And if one fixed a number, one would be doing exactly the same thing as was done at present to fix the net income target. The system would work reasonably well if reserves accumulation were fixed in terms of the total level of credit outstanding; it would also work reasonably well when the level of the Fund's credit was rising. But what did one do if the level of credit outstanding fell? Would one actually run a deficit in order to get the reserve level down, at a time when perhaps the fall in the level of Fund's credit outstanding was due to some members, as was currently the case, making advance repurchases? The fundamental demand for new Fund credit was rising, but much of it was being offset by voluntary or advance repurchases. In that context, one would have to look carefully at the system, as it could have an important built-in element of asymmetry, if the level of the Fund's credit outstanding was falling.

A question had also been raised about the impact of the shortfall owed by the creditors in the SCA-2 on the Fund's income, the Treasurer recalled. That was an unusual way to look at the SCA-2. The shortfall was--he was happy to report for the first time in two-and-a-half years--beginning to fall because of the decision that the Board had taken at the end of April. The shortfall had come down SDR 40 million and was currently about SDR 210 million. When that shortfall by the creditors was made up, that would increase the level of the Fund's interest-free resources. The amount of remuneration and the size of the reserve tranches subject to remuneration tended to fall, and, therefore, it tended to increase the level of the Fund's interest-free resources, and was of benefit throughout for creditors and debtors, as well as for its "neutral" members. A reduction in the shortfall reduces the Fund's operational expense.

On the magnitude and components of the surplus for FY 1995, the Treasurer commented that the staff's forecasting performance had not been good. Nonetheless, the staff believed that a surplus in excess of target was likely. In the staff paper, the staff had indicated that a 5 percent rise in the SDR interest rate would yield SDR 10 million to the Fund. He believed there would be somewhat higher income on the use of Fund resources--not, to be sure, on the average level of the balances subject to charge, because they more or less balanced out with the Fund's operational expense, but on the all important service fee. And that depended very much on the timing of purchases. The Fund received income from its transactions essentially from the service fee. The rate of charge was so finely tuned to the Fund's operational expense, that it more or less balanced out. Also, the staff was hopeful that a surplus of SDR 45 million would be achieved when Zambia cleared its arrears around the year's end, or early 1995.

On whether special charges would be included in the excess in terms of the net income target, the Treasurer observed that the staff's answer on that had been fairly consistent: special charges would, or should, be included in the amount of income earned in excess of target, because if the staff knew for certain that such charges were going to paid, the staff would build the amounts into its forecasts of net income in the first place, and those would then be reflected in its rate of charge at present rather than when the repayments occurred.

The Chairman noted that Directors had approved the first decision. On the second and third decisions, he was somewhat disappointed.

One must view those decisions in the context of continuing the business of the Fund the Chairman added. In current circumstances, a strong financial position was essential for the Fund to continue with its activities and, if necessary, to take more risks. The Fund was also going to undertake a major review of the way in which the costs of the Fund would be financed. That would be a much more far-reaching discussion than the current one.

He would like to enter that forthcoming discussion, envisaged for July or early August, in a spirit of greater openness to ideas and to a possible consensus rather than to the fine-tuned calculation of majorities, the Chairman continued. It was in that spirit that he would like Directors, despite their different perspectives, to agree on his proposals. That would not create any particular precedent for the discussion that would take place in July, except perhaps to provide a climate of openness and of a common search for the best possible solution. In that context, he would again ask Directors to adopt Decision 2 and Decision 3.

Against that background, he wondered whether those who had earlier expressed a preference for 4 percent could accept 5 percent, the Chairman said. Without compromise, decisions could not be taken, and the Board would need to return to the matter again in the near future. Therefore, he would ask whether those who preferred 4 percent could accept 5 percent, and whether those who did not like his suggestion to have a gentlemen's agreement to return any excess income in the form of a retroactive reduction in the rate of charge could accept that proposal, provided that any shortfall in the Fund's net income target would be made up by an appropriate increase in the next year's net income target that would be reflected in the changes to the coefficient. That gentlemen's agreement could be reflected in the minutes of the meeting and would have the effect of a decision. It would be understood that the Executive Board had decided that, barring unforeseen circumstances, any excess income would be returned in the form of a retroactive reduction in the rate of charge after the end of the financial year; and, conversely, any shortfall in the Fund's net income target would be made up by an appropriate increase in the next year's net income target.

The Deputy General Counsel, replying to a question by Mr. Shaalan, explained that a "gentlemen's agreement" could be adopted by a decision of the Executive Board; however, that decision was not self-implementing, and would not automatically lead to a reduction in the rate of charge. At the end of the year, the Executive Board would need to assess whether the situation had changed, and would need to decide on the rate of charge.

The Chairman, following a suggestion by Mr. Geethakrishnan that the agreement be included in the text of the decision, proposed that language could be drafted and a decision circulated for approval on a lapse of time basis.

The Deputy General Counsel noted that at issue was the majority required for the decision in light of whether it was self-implementing. As presently proposed, the Board would return to decide on the use of excess net income for a reduction of the rate of charge by a 70 percent majority at the end of the financial year; there would be no automatic effect of the excess income on the rate of charge. For instance, understandings had been reached in the past on a subsequent retroactive reduction of the rate of charge under certain circumstances which did not affect automatically the rate of charge at the end of the year, and therefore only required a simple majority.

Mr. Shaalan said that, like the Chairman and other Directors, he was anxious to reach a consensus. Therefore he would go along with the

Chairman's proposal, provided that the retroactivity aspect was included in the decision.

Mr. Marino, recalling the discussion of SCA-2, said that he would be skeptical unless he could see the proposal set out clearly in the legal decisions. Was it intended that the Board agree at the present meeting that, if there was any excess of net income in FY 1995, automatically, and without any Board discussion, and without any required majority, that would be retroactively reimbursed through a reduction in the rate of charge?

The Deputy General Counsel replied that an understanding of the Executive Board that the rate of charge would be reduced retroactively unless circumstances had changed, would not have an automatic effect on the rate of charge. The Board would need to take a further decision by a 70 percent majority.

Mr. Shaalan said that, in other words, the Board would need to return to the matter again at the end of the year.

Mr. Geethakrishnan said that he remained unclear why the matter could not be made part of the decision at the present meeting. Why could not the understanding be incorporated as part of Decisions 2 and 3? If the requisite support for the understanding existed at the present meeting, why was the matter still relegated to a gentlemen's agreement to which the Board would have to return later? He recalled a previous instance, in which a Board decision had included language stating that an amount would be reduced, barring a later decision.

The Chairman explained that the decision would include the commitment of the Board to return any excess income in the form of a retroactive reduction.

Mr. Sirat suggested that, in a spirit of compromise, the decision should perhaps state that, unless a 70 percent majority considered that there were exceptional circumstances, a retroactive reduction could take place automatically.

Mr. Daïri remarked that, as the proposed decision included two symmetric corrections, there was no need to introduce the reference to exceptional circumstances. The assessment should be the same, whether there was net income or net loss. He did not see any case against an automatic correction at the end of the fiscal year.

Mr. Smee commented that he would like to support both Mr. Sirat and Mr. Daïri. Symmetrically speaking, if losses were to be recouped and surpluses were to be rebated, both actions should be considered automatic. Unless debtors wanted to argue that, because of exceptional circumstances, a shortfall should not be recouped, they should return to the Board to argue their case. Otherwise, the automatic procedure--as with surpluses--would be in force.

Mr. Al-Tuwaijri said that he could support Mr. Smee's proposal. But if there were no legal impediment, he would still prefer to have the language included in the text of the decision.

The Deputy General Counsel explained that either an understanding or a self-implementing decision could be adopted by the Board. An understanding would require a simple majority. A self-implementing decision would need to be adopted by a 70 percent majority. He also noted that the references to either "exceptional circumstances" or "unless the situation had changed" would prevent the decision from being self-implementing.

Mr. Smee considered that the qualifications should be omitted; the decision could always be changed, with a 70 percent vote, to the original, self-implementing text.

The Deputy General Counsel said that, under Mr. Smee's suggestion, the text would read: "Any net income for financial year 1995 in excess of the target amount of net income"--and he understood that to be 5 percent--"of the Fund's reserves at the beginning of that financial year shall be used to reduce retroactively the proportion of the rate of charge to the SDR interest rate for financial year 1995. If net income for financial year 1995 is below the target amount for that year, the net income target for financial year 1996 shall be increased in the equivalent of that shortfall."

The Chairman stated that Decision No. 2 and Decision No. 3 were endorsed, including the addition read out by the Deputy General Counsel.

The Executive Board took the following decisions:

Disposition of Net Income for FY 1994

The Fund's net income for financial year 1994, equal to SDR 74,149,193, shall be placed to the Special Reserve.

Decision No. 10704-(94/52), adopted
June 8, 1994

Net Income Target for FY 1995; Rate of Charge on Use of Fund Resources; and Retroactive Reduction of Rate of Charge for FY 1995 and Increase in Net Income Target for FY 1996

1. The target amount of net income for financial year 1995 shall be 5 percent of the Fund's reserves at the beginning of the financial year.

2. Effective May 1, 1994, the proportion of the rate of charge referred to in Rule I-6(4) to the SDR interest rate under Rule T-1 shall be 115.1 percent.

3. Any net income for financial year 1995 in excess of the target amount of net income of 5 percent of the Fund's reserves at the beginning of that financial year shall be used to reduce retroactively the proportion of the rate of charge to the SDR interest rate for financial year 1995. If net income for financial year 1995 is below the target amount for that year, the net income target for financial year 1996 shall be increased by the equivalent of that shortfall.

Decision No. 10705-(94/52), adopted June 8, 1994

Implementation of Burden Sharing-Second Through Fourth Quarters of FY 1995

Section I. Principles of "Burden Sharing"

1. The financial consequences for the Fund which stem from the existence of overdue financial obligations shall be shared between debtor and creditor member countries.

2. The sharing shall be applied in a simultaneous and symmetrical fashion.

Section II. Determination of the Rate of Charge

1. During the second through fourth quarters of financial year 1995, the rate of charge for financial year 1995 referred to in Rule I-6(4) shall be adjusted in accordance with the provisions of Section IV.

2. When estimating income for purposes of Rule I-6(4)(a) and (b), no projection shall be made of deferred income. The calculation of actual net income under Rule I-6(4)(b) shall include the proceeds of adjustments for deferred income under Section IV, paragraph 2.

Section III. Amount for Special Contingent Account-1

An amount equivalent to 1.25 percent of the Fund's reserves at the beginning of the financial year shall be generated each quarter during the second through fourth quarters of financial year 1995 in accordance with the provisions of Section IV, and shall be placed to the Special Contingent Account-1 referred to in Decision No. 9471-(90/98), adopted June 20, 1990.

Section IV. Implementation of Burden Sharing

1. During the second through fourth quarters of financial year 1995, notwithstanding Rule I-6(4)(a) and (b) and Rule I-10, the rate of charge referred to in Rule I-6(4) and the rate of remuneration prescribed in Rule I-10 shall be adjusted in accordance with the provisions of this Section.

2. (a) In order to generate the amount to be placed to the Special Contingent Account-1 in accordance with Section III, the rate of charge and, subject to the limitation in (c), the rate of remuneration, shall be adjusted in accordance with the provisions of this paragraph, so as to produce equal amounts of income.

(b) If income from charges becomes deferred during an adjustment period as defined in (d), the rate of charge and, subject to the limitation in (c), the rate of remuneration, shall be further adjusted, in accordance with the provisions of this paragraph, so as to generate, in equal amounts, an additional amount of income equal to the amount of deferred charges. For the purposes of this provision, special charges on overdue financial obligations under Decision No. 8165-(85/189) G/TR, adopted December 30, 1985, as amended, shall not be taken into account.

(c) No adjustment in the rate of remuneration under this paragraph shall be carried to the point where the average remuneration coefficient would be reduced below 85 percent for an adjustment period.

(d) The adjustments under this paragraph shall be made as of August 1, 1994, November 1, 1994, and February 1, 1995:

shortly after October 31 for the period August 1 to October 31;

shortly after January 31 for the period November 1 to January 31;

shortly after April 30 for the period February 1 to April 30.

(e) The operation of this decision shall be reviewed when the adjustment in the rate of remuneration reduces the remuneration coefficient to the limit in (c) above.

3. (a) Subject to paragraph 3 of Decision No. 8780-(88/12), adopted January 29, 1988, the balances held in the Special Contingent Account-1 shall be distributed in accordance with the provisions of this paragraph to members that have paid additional charges or have received reduced remuneration

as a result of the adjustment, when there are no outstanding overdue charges and repurchases, or at such earlier time as the Fund may decide.

(b) An amount equal to the proceeds of any adjustment for deferred charges shall be distributed, in accordance with the provisions of this paragraph, to members that have paid additional charges or have received reduced remuneration, when, and to the extent that, charges, the deferral of which had given rise to the same adjustment, are paid to the Fund. Distributions under this provision shall be made quarterly.

(c) Distributions under (a) or (b) shall be made in proportion to the amounts that have been paid or have not been received by each member as a result of the respective adjustments.

(d) If a member that is entitled to a payment under this paragraph has any overdue obligation to the Fund in the General Department at the time of payment, the member's claim under this paragraph shall be set off against the Fund's claim in accordance with Decision No. 8271-(86/74), adopted April 30, 1986, or any subsequent decision of the Fund.

(e) Subject to paragraph 4 of Decision No. 8780-(88/12), adopted January 29, 1988, if any loss is charged against the Special Contingent Account-1, it shall be recorded in accordance with the principles of proportionality set forth in (c).

Decision No. 10706-(94/52), adopted
June 8, 1994

5. OFFICE SPACE - PHASE III - REPORT BY STAFF

The staff representative from the Administration Department noted that the Foggy Bottom Association had again addressed a letter to Executive Directors and the time was thus opportune to bring the Board up to date on the status of the alley closing. First, the issue for the Foggy Bottom neighbors was the feeding program managed by the Western Presbyterian Church, which had recently moved four blocks closer to Foggy Bottom. The Fund had no control over that program. It had no leverage to exert on the church in respect of the feeding program, and he would not suggest that the Fund attempt to influence the church in the conduct of its feeding program. However, the current objective of the citizens association was to force the Fund to open a competitive feeding program in its new addition. The association was no doubt hopeful that such a program would attract the homeless away from their neighborhood.

Second, in designing and building the new church, a very modern and efficient new kitchen had been constructed specifically to enhance the feeding program, the staff representative continued. In that context, rather than displacing a needed social service, as had been suggested in the letter, the Fund had been instrumental in retaining and enhancing a needed social service just a few blocks away.

Third, a question regarding the possible release of the Fund's contract with the Western Presbyterian Church had been raised as a major point of contention, the staff representative noted. On advice of both Fund and outside counsel, the Fund had refused to provide the citizens or the D.C. City Council with a copy of that contract, as it was irrelevant to the alley closing issue. He had offered a copy of the contract to a mediator who had been appointed by the D.C. City Council, but the mediator had refused to get involved in the debate over the contract, also seeing it as basically irrelevant to the alley closing issue. The objective of the citizens in their quest for the contract was to see whether the contract could be rescinded. That, as he had pointed out to the City Council members, was a moot point, now that the old church had been razed.

Fourth, the Fund had been charged by the Chairman of the D.C. City Council to take two actions in connection with the alley closing, the staff representative commented. The first was to participate in a nonbinding mediation effort with the local citizens, facilitated by a professional mediator chosen by the Chairman of the City Council. That process had commenced. He had been in contact with the mediator on several occasions. The staff had not yet met with the Foggy Bottom citizens. The second action was to contribute to another downtown feeding program in an amount equal to that normally required of owners in connection with all alley closings. In response, the staff had agreed, in principle, to contribute a total of $100,000 to two feeding programs managed by the First Congressional Church, which was located on H and 10th streets, on the condition that the alley be closed. Subsequently, he had spoken with Chairman Clarke of the D.C. City Council, who had confirmed that the staff had met his demands.

As a final point, the staff representative said that it was the view of the Fund's legal advisors, and had been confirmed by his own contacts within and close to the City Council, that Chairman Clarke did not have the political will to force the Fund's alley closing at the present time. His office had asked whether the Fund would mind postponement to the fall, with no assurance that the efforts would be any more successful at that time. Should the delay also force the Fund to postpone construction, it would cost about $1 million each month in added rental costs, starting in 1997 when it was planned to move into the new building. There would also be an as yet unknown increase in construction costs, because the construction process had already begun, as could be seen. Thus, the unfortunate conclusion was that the Fund probably had no option but to sue the District of Columbia. A recommendation would be presented to management over the course of the next two weeks. Thus, he would recommend that, in the current circumstances, any contact with the Foggy Bottom Association be avoided for the following reasons. First, the Fund staff was currently in mediation with Foggy Bottom. Second, as would be recalled, the Board had already agreed that, should it become necessary, the Fund could sue the city to force the alley closing. As the Fund might be forced into that position very shortly, he would recommend avoiding Board contact with the citizens.

Ms. Lissakers asked for additional information about what exactly was at issue in the mediation between the Fund and the Foggy Bottom Association or community. Second, had she understood the staff to say that the City Council had not approved the alley closing and that the Chairman of the City Council had said that he could not bring it to a successful vote at present, or that he did not want to bring it up? Third, if the Fund were to sue the city, what exactly was the legal basis for the suit?

The staff representative from the Administration Department replied that at issue in the mediation was the feeding program. The mediator and he both felt that little would come of the mediation process as the Foggy Bottom citizens really wanted to move the feeding program, and the Fund had no influence over the church. The church was not involved in the mediation; it was the Fund and Foggy Bottom. Perhaps the citizens would ask the Fund to contribute to a feeding program closer to Foggy Bottom than the one on which he had reached tentative agreement with the Chairman of the City Council, but he was not very optimistic on that score.

On the legal basis for the suit, the staff representative stated that, by law, an alley should be closed if all owners of land surrounding that alley agreed that there was no use for the alley. The Fund owned the alley and all the land surrounding it. There was no other condition legally for an alley closing. The D.C. City Council had not agreed to close the alley. The Chairman of the City Council was reluctant--or probably unwilling--to place the matter before the City Council. He would have one opportunity to do that before the fall, and that was on June 20. He had no indications that the Council Chairman was going to do that. In fact, the staff had every indication that he would not. Hence, he did not see that the Fund had a reasonable chance of getting the alley closed before the summer recess of the D.C. City Council, which meant the process would begin again in the fall.

Ms. Lissakers said that she remained unclear how the law worked in respect of the case at hand. On the one hand, an elected body must apparently decide to close the alley; on the other hand, there were statutes which would appear to make the closing automatic, unless there were grounds for not permitting the owners of the alley to close it.

The staff representative from the Administration Department replied that, traditionally, the D.C. City Council had attached a number of conditions to alley closings. The term was called a "linkage." The linkage was not legally required; however, given the expense of any delay in construction, developers generally made the contributions requested. It was the staff's feeling that, through the courts, the alley closing could be forced, and the issue of the other payments could be brought to the fore.

The Chairman, noting that he was not familiar at all with the legislative process in the United States, asked how soon the case might be taken up.

The staff representative from the Administration Department observed that the staff had been advised that an accelerated hearing of the case was possible, which would probably force a decision by September. The staff also felt that it would be possible to obtain a permit to begin digging even without the alley closing. That would be known within a week. The concern was that, if the Fund waited until the fall to restart the alley closing process, without going to court, a time constraint would arise by the following spring. There was no guarantee that the alley would be closed.

Mr. Geethakrishnan wondered whether, if the Fund took the city to court, it would not get the construction permit earlier.

The staff representative from the Administration Department replied that the hope was to obtain the clearance over the course of the next week, before the suit was brought.

Ms. Lissakers asked about the reports in the press of a separate Zoning Board ruling on the alley.

The staff representative from the Administration Department noted that the Zoning Board had approved the building. Zoning, unfortunately, had nothing to do with alley closings.

Mr. Evans considered that the case involved two types of issues: legal questions and public relations. He wondered whether it would be possible to pursue the mediation course while, at the same time, continuing with the legal route. If something could be gained through mediation, that would be helpful.

The staff representative from the Administration Department replied that he had been in close contact with the mediator, who was attempting to arrange a meeting between the Fund and the Foggy Bottom citizens. Whatever came out of such a meeting would be nonbinding. The hope was that the two sides could be brought closer together, although the Fund was not in a position to move the feeding program, and that was the issue for the citizens.

Ms. Lissakers inquired whether the staff had told the Foggy Bottom Association that the Fund had in fact offered to provide the mediator with a copy of the contract with the church. She recognized that the contract offered no promise of a settlement, but every effort should be made to avoid ill will.

The staff representative from the Administration Department said that he had not done so, although he assumed that the mediator had. The preference had been to work through the mediator, although he could inform the association if the Board so wished.

Mr. Posthumus said that he had two questions. First, assuming that the Fund could influence the church to move its feeding program, would that not create similar problems with citizens groups in other parts of the city? Second, he wondered what role, if any, the Federal Government played in the matter at hand.

The staff representative from the Administration Department remarked that, in fact, the church that he asked about its willingness to accept a contribution, in principle, was a church in the inner city; it was not in a residential neighborhood. It was rather well known for running two very effective feeding programs: a morning program and an evening program. In that context, if it had been possible to move the program, no citizens' groups would have been affected. On the second question, the Federal Government was not involved in the matter at all.

Mr. Waterman commented that he remained uneasy, in part because he did not understand the processes completely. Perhaps further reflection would be helpful, but he certainly would feel uneasy about proceeding with the digging process before the Fund obtained approval for the alley closure, both in terms of the money that the Fund could be spending and also in terms of the implications of such an action for the ongoing negotiations.

Mr. Al-Jasser agreed that it might not be helpful if the Board were to respond to the letters addressed to Executive Directors, although each could, of course, do what he or she saw fit. However, because the issue was becoming so tangled, it might be worth responding--or at least explaining the Fund's position--as a public relations matter. If so, the Chairman of the Board was probably the best person to write such a letter; and to avoid misunderstandings, misstatements, or misrepresentations of the issue at hand, it would be advisable if the letter were prepared on advice from legal counsel. He assumed that the problem was a true difference of opinion between the Fund and the Foggy Bottom Association, and not due to poor communication or a lack of sensitivity by the Fund toward the community. It seemed very clear to him that the feeding program belonged to the church and not to the Fund and, in that context, the Fund should not be blamed for something that was none of its business. However, people looking at the case from different angles might interpret it differently. The point was to ensure that the Fund did everything possible to at least clarify its position with all the parties involved.

He understood that an agreement had been reached with the Chairman of the City Council on additional feeding programs, but that he had not kept his end of the bargain, Mr. Al-Jasser continued. He wondered whether the Chairman of the City Council had explained his failure to deliver on the agreement and whether others knew of the bargain that had been struck.

He also understood that a demonstration had been led by Rev. Jesse Jackson, apparently in support of the church's new feeding program, Mr. Al-Jasser said. In that context, there appeared to be at least some in the city who were supportive of the approach taken by the Fund. Was the Fund still in the good graces of other important citizens of the city? Was the Fund explaining its situation? If the Fund were to go to court, even if the law were on its side, the Fund might lose its good relations with the public.

Ms. Lissakers asked whether the church had begun its feeding program in the new facility and whether the Zoning Board had approved that program. Also, she hoped that, before the Fund initiated a lawsuit against the city, the Executive Board would have an opportunity to discuss the matter.

The staff representative from the Administration Department responded that the church had begun the program, although not with the support of the Zoning Board; indeed, the Zoning Board had attempted to block the program, but a federal judge had ruled in favor of the church. On the reluctance of the Chairman of the D.C. City Council to fulfill his part of the bargain, the matter was somewhat complicated. The D.C. City Council was made up of members from each ward. Mr. Clarke, the Chairman, had an agenda, which was to push through something called the New D.C. Comprehensive Plan. He was at odds with other members of the City Council on many of the items in that plan. One of the key items was that churches should have a right to conduct feeding programs. He had carried that issue against the objection of several members of the City Council, including those from Ward 2, which included Foggy Bottom. Chairman Clarke, whose real interest was to get the comprehensive plan through, did not want to expend his political energy on the alley closing. That was his reading of the situation, confirmed by Chairman Clarke's assistant.

The Fund's case and its position had been made clear both to the newspapers and to various citizens' groups, the staff representative continued. And the Fund had gained a certain measure of support for its position, but not from the Foggy Bottom citizens, who had always hoped that the Fund would wield sufficient leverage over the church to move the feeding program. The Fund would, of course, continue to plead its case with the citizens.

Mr. Smee observed that the Fund appeared to be involved in a classical case of "not in my neighborhood," and he was certain that all those people that lived in Foggy Bottom were in favor of soup kitchens as long as the feeding programs were not conducted next door to them. As he understood it, the Fund had the legal right to close this alley and to start building. In practice, developers did usually contribute something to smooth the path. The citizens group was taking advantage of that practice to apply political pressure on the Fund and to get around the legal means of redress. The solution for the Fund was the same that the church had employed, namely, the courts, and he was certain that a lawsuit was the only way to get the building started. He hoped the Fund would not knuckle under to the pressure. He had always believed that possession was nine tenths of the law and, in that context, he felt that the Fund should begin digging as soon as possible.

The Chairman asked whether it was true that Mr. Clarke only needed to be forced by the courts to go ahead with the closing of the alley.

The staff representative from the Administration Department said that the situation was not an easy one to read. He was hoping that, assuming the Board agreed to go ahead with the suit, he would be able to bring the filing to Mr. Clarke's attention and get his agreement to avoid the suit. However, it was also possible that Mr. Clarke would need to be forced by the courts.

Mr. Posthumus, noting that he had been among those who had called for a meeting of the Board on the issue at hand, said that he had wanted clarification of the situation; and he had received that. He had also wondered about the role of the Federal Government, on a political rather than a legal level. Had any effort been made to ask the U.S. authorities whether they could support the Fund and perhaps assist in reaching some compromise?

He recognized that, in respect of the building process, the Board had in the past not always acted in the most efficient and helpful way; indeed, it had even helped to delay certain decisions, and he knew a number of his colleagues were sorry about those delays. In that context, he agreed with Ms. Lissakers that the Board should be involved before the Fund went to court, but surely that did not require a long staff paper, a three-week circulation period, and 24 statements by Directors. It should be sufficient to keep the Board informed and satisfied that management and the staff were acting properly and with diligence.

Ms. Lissakers replied that she had not been calling for a formal Board consideration of the legal issues. However, the Board deserved at least an informal discussion or some advance notification, to avoid any political embarrassment that might arise if, for example, a story were to appear in The Washington Post that said the Fund was suing the city over the alley, which might coincide with the day that Congress was voting on the enhanced structural adjustment facility.

Mr. Kaeser agreed with the view of Mr. Smee. The Fund should not be swayed by extortion and should use the legal means at its disposal to move forward.

Mr. Verjbitski said that he shared the concerns of Ms. Lissakers and Mr. Al-Jasser that bad publicity for the Fund would be undesirable, especially at present. He wondered whether there were any unorthodox approaches that could be explored, for example, to sell the land to the U.S. Government and lease it back for some indefinite period. Then the U.S. Government, and not the Fund, could deal with the city.

Ms. Lissakers remarked that the U.S. Government would not buy the land from the Fund.

The Chairman said that it appeared Directors were agreed that it would not be proper to answer the letter at the present time. If necessary, at a certain moment, he could, on behalf of the Board, provide a courteous indication that the Executive Board did not feel it appropriate to enter into such discussions, and that the Board only looked forward to an amicable resolution of the problem. He would notify Directors, with a few days' notice, of any decision to go to court, and he would call a brief meeting for the purpose, with a view to avoiding political damage.

Mr. Al-Jasser repeated his view that the Fund should be extremely careful about the issues of public relations and political sensitivities. However, once that was done, he agreed with Mr. Smee and Mr. Kaeser that the Fund should go ahead with its suit.

6. AZERBAIJAN REPUBLIC - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Azerbaijan Republic (SM/94/116, 5/11/94; and Sup. 1, 6/6/94). They also had before them a background paper on recent economic developments in Azerbaijan Republic (SM/94/128, 5/26/94).

Mr. Kaeser made the following statement:

> Since the last Article IV consultation in March 1993, the Azerbaijan Republic has gone through another year of ordeal. The escalation of the Nagorno-Karabakh conflict generated major political tensions within the country and provoked a change of government. Over one fifth of the Azerbaijan territory remains occupied in spite of the numerous resolutions of the UN Security Council. The number of refugees has risen to about 15 percent of the population.
>
> The conflict has had a negative impact on the economy, adding to the difficulties caused by the disruption of trade and payments among the countries of the former Soviet Union. The loss or the destruction of four thousand agricultural and industrial enterprises has caused a fall of 10 percent of the industrial and of 25 percent of the agricultural production. The uncertainties and tensions created by the war have discouraged foreign investment, with particularly damaging consequences for the oil and natural gas industry. Defense expenditures and refugee support are placing a heavy toll on public finances, absorbing one fourth of the State budget. These factors, together with acute shortages of raw materials and other inputs caused by the settlement breakdown with the countries of the former Soviet Union, led to a real GDP decline of 13 percent in 1993, bringing

the cumulative fall since 1988 to 44 percent. Tentative estimates show similar output and GDP patterns for the first four months of this year.

In spite of these adverse circumstances, the Government remained firm in its commitment toward market-oriented reforms and positive results could be obtained. In particular, it proved possible to contain economic imbalances, introduce a national currency, liberalize most prices, and to make headway in the reform of the financial sector, as well as in the development of the legal and institutional framework of a market economy.

In recent months, as the prospects for a peace settlement substantially improved, the Azerbaijani authorities, anxious to prepare for the postwar period, made major efforts to speed up the reform process, aiming in particular at reducing inflation and promoting exports. This endeavor was facilitated by the change at the head of the Azerbaijan National Bank.

The revised state budget for 1994, approved recently by the Parliament, shows, according to the Fund classification, a deficit of 5.7 percent of 65 GDP. My Azerbaijani authorities are firmly committed to covering a large part of the deficit through additional receipts from VAT and excise tax, property tax, the proceeds from the privatization of trade and sales facilities, and from the sale of bonds; the republic's national bank will limit its financing of the deficit to about 20 percent of the total amount. In order to bring more efficiency and transparency into the management of the budget and tax administration, the authorities intend to create a treasury, with the technical assistance of the Fund.

The Azerbaijani authorities requested the technical assistance of the Fund for the preparation of anti-inflationary decrees. These decrees should incorporate measures to terminate subsidized credits, raise the real interest rates level, and increase the reserve requirements of banks. In order to strengthen the monetary control and exert a closer monitoring of credit activity, it has been decided that the two largest specialized banks, Prominvestbank and Agrobank, should open correspondent accounts with the central bank on July 1, 1994.

On May 24, 1994 the central bank suspended the peg of the manat with the Russian ruble and let the exchange rate be determined by market forces. Following the Fund's recommendation, the Azerbaijani monetary authorities intend to promote the development of an interbank foreign exchange market.

Measures have also been taken to liberalize trade, and promote exports, inter alia, through a reduction of the surrender requirements of enterprises. As regards the institutional reform effort, the adoption of laws on enterprises, bankruptcy, and joint stock companies, as well as a law on privatization, should be passed in the near future.

The above mentioned measures represent building stones for a comprehensive program fostering free market structures and the development of the private sector, which the Azerbaijani authorities wish to finalize with the help of the Fund. As stated by the President of the Azerbaijan Republic in a recent letter to the Managing Director, they also wish to have the financial support of the Fund as soon as a peace settlement is agreed.

The Azerbaijani authorities would like the Board to know that they highly praise the technical assistance provided by the Fund and thank the staff and the resident representative for their work and dedication.

Mr. Al-Tuwaijri made the following statement:

In common with the other states of the former Soviet Union, the Azerbaijan Republic has experienced enormous disruptions to trade and production over the past few years. Over and above these common problems, Azerbaijan is burdened with serious disruptions caused by the Nagorno-Karabakh conflict. Indeed, as noted in the staff's helpful statement, the conflict has resulted in the loss of 25 percent of agricultural production and 10 percent of industrial production, and has created a major refugee problem. I hope that the recent peace efforts, which are summarized in the supplement to the staff report, will pave the way for a resolution of this conflict. Regional peace is essential if Azerbaijan is to take full advantage of its substantial resource endowment, and to realize its medium-term growth potential.

Despite these major difficulties, I am encouraged by the authorities' renewed efforts to put in place important elements of an economic reform program, particularly in the fiscal and exchange system areas. Full implementation of these reforms as a first step toward a comprehensive adjustment effort is particularly crucial in view of the marked deterioration in the financial situation.

The 1994 approved budget provides an important step toward medium-term fiscal consolidation. Indeed, coupled with additional planned fiscal measures, the deficit is expected to fall from 14 percent of GDP in 1993 to less than 2 percent in 1994. Furthermore, the measures aimed at broadening the tax base and enhancing the buoyancy of the tax system are important. Strengthening the tax administration through implementation of the recent FAD mission's recommendations should also facilitate achievement of the revenue target. On the expenditure side, the elimination of major food subsidies is a welcome step.

Despite these efforts, it remains uncertain whether the projected fiscal consolidation will be achieved, as Parliament may not approve the proposed revenue and expenditure measures. In addition, the depreciation of the exchange rate and the uncertain outlook for inflation further clouds the fiscal picture. Consequently, the authorities will need to monitor developments closely and persevere with their commitment to the fiscal objectives, including adherence to a strict wage policy.

Fiscal consolidation will also be greatly enhanced by the resolution of the enterprise arrears problem. Delays in resolving this mushrooming problem would not only weaken the fiscal position, but could constrain output growth and compromise wage policies. Therefore, I agree with the staff on the need to accelerate the restructuring of the public enterprise sector through privatization, as well as strengthened enterprise management and the imposition of hard budget constraints. Implementation of effective bankruptcy procedures will also be crucial to the resolution of this problem. Bold measures in instituting clear private property rights would greatly facilitate all of the above.

A strong fiscal policy stance, coupled with better management of public enterprises, should facilitate the conduct of tight monetary and credit policies for the period ahead. Such policies are essential if inflation is to be reduced, thereby promoting a stable exchange rate. Elimination of subsidized credit and movement to a market-determined interest rate are also important. These measures would need to be accompanied by enhancement of bank supervision, especially in view of the increase in public enterprise arrears, as well as the proliferation of private banks--more than 170 private banks by last count. In this regard, the recent measures that have been implemented in this area are a step in the right direction.

Turning to the external sector, the focus on greater market determination of the exchange rate is particularly encouraging. This is especially true in view of the recent sharp increase in the real effective exchange rate and its impact on the trade balance. However, I agree with the staff that more needs to be done, particularly in such areas as reducing surrender requirements and deepening the foreign exchange market. Measures along these lines, supported by appropriate macroeconomic and structural reforms, should set the stage for Azerbaijan to achieve its full economic potential.

Mr. Wire made the following statement:

The Azerbaijan Republic is a country of vast natural resources and fertile land, and its people have a strong entrepreneurial spirit. Unfortunately, the Azerbaijani authorities seem to have accomplished little in 1993 to begin capitalizing on their country's enormous economic potential and spurring a recovery in exports or output. If anything, the economy has become increasingly destabilized over the last year, reflecting and contributing to the country's political instability. After a somewhat promising start, fiscal and monetary policies were loosened. The introduction of the manat, while welcome, was mismanaged and exchange rate and trade policies remained very distortionary. Minimal progress was made on structural reforms, and the Government continued to play a very direct and pernicious role in the economy. Azerbaijan's military conflict with the Nagorno-Karabakh Armenians also continued to consume a huge chunk of scarce resources and distract the Azerbaijani leadership from dealing with their pressing economic problems.

Before turning to the economic agenda, we would emphasize that the military conflict remains an extremely large obstacle to the country's economic recovery. Over 20 percent of Azerbaijan's territory is occupied, 15 percent of the population are refugees, and about 25 percent of the budget is expended on war-related expenses. Progress toward resolving the conflict is critical, so that resources and the leadership's attention can be redirected to the country's economy and normal interregional trade can resume. We hope that all approaches are being pursued to achieve a peaceful settlement of the conflict at the earliest moment.

The staff's excellent report well documents the economic developments over the last year. As we fully share the staff's assessment, I would like to focus my comments on the gulf that remains between the faint glimmers of hope seen in the staff's supplement of June 6, and the key steps Azerbaijan must take to begin its recovery and realize its vast economic potential.

In this regard, the reform plans and recent measures described by the staff are encouraging to the extent that the Azerbaijanis appear to understand that current economic policies are not sustainable. However, in virtually every respect, important commitments and concrete action are still lacking.

As an overall comment, we do not see any indication that these various proposals are being framed as part of a coherent plan. For instance, glaringly missing from the policy plans, particularly those relating to the state budget and its implications for monetary policy, is discussion of an inflation objective that could provide a point of orientation for financial policies.

As far as specific policies go, despite the meaningful progress late last month toward exchange rate liberalization, it is still not unified, nor even necessarily representative. Furthermore, retention of distorted surrender rates and requirements strongly discourage capital repatriation, and reserve management procedures run counter to the goal of bolstering the role of the central bank.

Potentially significant plans to tighten the budget are outlined, but they remain only proposals, and the staff has expressed a number of doubts about the validity of budgetary projections and assumptions. As such, it is hard to see the necessary immediate significant tightening in fiscal policy. Further work is needed on the budget. In our view, key components of this effort must include no restoration of price subsidies, accelerated energy and bread price liberalization, a reduction in support for state firms, and efforts to reduce war expenditures by resolving the military conflict.

In the absence of a tighter fiscal stance, the Azerbaijan National Bank is still forced to finance the large government deficit, as well as issue significant, often subsidized, credits to state firms. In addition, in the monetary area, policies to improve the independence of the central bank, shift to real positive interest rates, immediately eliminate credit subsidies, and improve bank supervision are among the key measures that are missing.

We still see no real indication that the Azerbaijanis intend to give market forces free rein in the economy. The Government has been loath to reduce its direct involvement in the economy, with state orders making up 30-50 percent of the output of firms and many firms still reporting directly to state ministries. Reducing the state's role in production must be a critical immediate step. We encourage Azerbaijan to use the World Bank's general privatization outline as the basis for discussion on accelerating and restructuring its privatization plans. The Government's currently inactive privatization plan does not envision privatizing the country's most important firms until 1998. This is far too slow.

In view of falling energy output and a weakening current account position, Azerbaijan critically needs to finalize plans for foreign investment in its energy sector. Likewise, the trade regime must be reformed to eliminate impediments to exports, in particular, and to permit repatriation of export proceeds.

In conclusion, Azerbaijan has a lot of work ahead to flesh out its nascent economic proposals and put them into a coherent policy framework, before it will have anything approaching the comprehensive reform plan suggested by the staff. Whether or not that effort moves forward, we strongly encourage the Azerbaijani authorities to garner the immediate benefits that could be gained from finalization of the foreign investment agreements that are now on the table and from progress toward a peace settlement.

Mr. Kural made the following statement:

Azerbaijan has entered the reform process while facing a multitude of uncertainties, which doubtless made the formulation and implementation of the reform program a very challenging task. The continuation of hostilities over Nagorno-Karabakh, despite the May 16 cease-fire, poses an obvious threat to a successful restructuring of the economy. An early settlement would be most desirable.

The most alarming trends of 1993 were declining output, a deterioration of the fiscal position, narrowing of the current account surplus, and accelerating inflation. In view of the need for fundamental economic restructuring and the collapse of the trade and payment system of the former Soviet Union, it is hard to see how a further decline in output can be avoided this year, however desirable that might be.

The adoption of a national currency, mostly complete by midyear, is seen as a key element of the economic reform effort. Setting the official manat exchange rate on a weighted average of exchange rates quoted by commercial banks is a promising first step toward establishing an interbank foreign exchange market. The staff argues that the most appropriate exchange rate regime for the manat would be convertibility, as the conditions needed for a peg cannot be achieved in the short run. Though the staff is right about the prerequisites for a peg, it is equally true that the adoption of a market-determined rate requires the development of an interbank foreign exchange market and financial institutions to participate in it. Experience has shown that market-determined exchange rate systems are subject to enormous depreciations, generating inflationary pressures and great uncertainties, which undermine confidence in the reform and stabilization program. Moreover, given Azerbaijan's oil exports, a peg to the dollar might be a sensible solution. Could the staff comment on the prospects for a market-determined exchange rate, assuming the authorities take the additional recommended actions and the probable impact of the most recent exchange rate policy changes on the approved budget?

The establishment of a two-tier banking system with a legal and regulatory framework for state and commercial banking is crucial. These should be accompanied by the introduction of efficient instruments for direct and indirect monetary control, and a functioning system of banking supervision to monitor compliance with banking regulations and financial developments in the economy. The recent tightening of prudential regulations and setting of minimum capital requirements for commercial banks are steps in the right direction.

In the fiscal area, defense, refugees, and social expenditures account for most of the approved state budget for 1994. The establishment of a social safety net, needed to cushion the substantial increase of unemployment, is an especially severe burden. Attempts to offset these increased expenditures by raising taxes during the reminder of the year would probably cause severe administrative problems. I therefore also urge the authorities to strengthen tax collection and bring the tax administration up to the standard for a market economy. Further technical assistance to develop adequate statistics will be essential to achieving greater transparency and making a better assessment of the public sector position.

Another problem requiring a quick solution is the accumulation of wage and interenterprise arrears. Strengthening financial discipline by reducing the budget deficit, discontinuing subsidized credits, and adjusting the refinance rate toward a positive real level must precede a successful enterprise reform and disinflation. The social safety net will need to be better targeted to ease the burden of these measures on low-income groups and maintain popular support for reform.

This leads me to income policy. The elimination of consumer subsidies in the second half of 1993 is essential to the economic reform program, but I share the authorities' concern about the bread subsidies which represent a major food item for the refugees. Can the staff assess the authorities' recent plan to raise bread prices? Wage adjustments, on the other hand, have to be approached cautiously: the authorities' intention to raise the minimum wage in the coming weeks is likely to cause inflationary pressures and jeopardize the stabilization program. In view of the production losses suffered by Azerbaijan's economy, at least a temporary reduction of real wages would seem to be in the cards.

Finally, let me comment on the structural reforms. Up to now, progress with structural reforms has been rather slow. Although a privatization law was passed in January 1993, no program has been adopted. Experience in Eastern Europe has shown that transparent, business-friendly legislation is necessary for successful privatization and the attraction of foreign investment.

Privatization must also be supported by restructuring and strengthening the financial discipline of the entities that remain in the hands of the state. This entails the creation and enforcement of bankruptcy laws to facilitate the enforcement of contracts and the closure of nonviable enterprises.

I hope that efforts to resolve the Nagorno-Karabakh conflict will be successful, and wish the Azerbaijani authorities well in the efforts to adjustment their economy and realize its growth potential.

Mr. Mojarrad made the following statement:

The protracted war over the disputed enclave of Nagorno-Karabakh has left a legacy of destruction, and constrained the Azerbaijani authorities' reform efforts. Indeed, 4,000 agricultural and industrial complexes have been destroyed; and more than 1 million refugees have fled to other regions, leading to substantial declines in industrial and agricultural output. Apart from the war's legacy of physical destruction and human suffering, the required defense and refugee-related spending have placed a heavy burden on domestic resources. In addition, the usual dislocation associated with transition to a market economy, further disruptions in trade and payments links with other countries of the former Soviet Union, as well as the escalation of the conflict over the past year, were important contributing factors in Azerbaijan's economic difficulties during 1993. Output declined for the fifth consecutive year, the fiscal and external positions worsened, and inflation accelerated in the latter part of the year, reflecting the adverse developments since the outbreak of the conflict in 1988.

Against these major difficulties, Article IV consultation discussions have been held in Baku regularly since Azerbaijan became a member of the Fund, reflecting the authorities' firm commitment toward market-oriented reforms and their desire to implement the Fund's policy recommendations, even under difficult circumstances. Also, the adoption of a national currency in the face of political and economic uncertainties is commendable. We are also encouraged by the authorities' renewed efforts to install important elements of an economic reform program aimed at reducing inflation and promoting exports.

In the area of fiscal policy, we concur with the staff that a key objective should be to reduce recourse of government and state-owned enterprises to domestic bank financing. The severe contraction in economic activity, as well as heavy fiscal demands of the war and refugees, have no doubt complicated the task of creating fiscal policy. Nonetheless, it is encouraging to note that the revised state budget deficit, approved by the Parliament, has been cut by half to 6 percent of GDP, reflecting substantial curtailment of the budget deficit in 1994. There is a need to strengthen expenditure management and improve tax administration. For this purpose, the authorities intend to establish a treasury within the Ministry of Finance. The technical assistance being provided in this area by the Fiscal Affairs Department was timely and appropriate. We support the authorities' request for further technical assistance in order to implement the staff's recommendation.

Monetary developments over the past year signaled a substantial growth of monetary and credit aggregates. The authorities recognize that the large financing requirements of government and state-owned enterprises have been the driving force behind liquidity expansion. The authorities' plans to move toward strengthening monetary control through tightening of prudential regulations and minimum capital requirements for commercial banks are welcome. The Azerbaijan National Bank should be allowed to exercise independence in the conduct of monetary policy, through strong supervision of the banking system. While the authorities' focus on greater market determination of the exchange rate is a step in the right direction, more needs to be accomplished, along the lines recommended by the staff, as soon as circumstances allow.

On the structural front, reforms should be pursued with more determination, particularly in implementing a privatization program. Given the importance of agriculture in Azerbaijan, we were surprised by the uncertain timing of the passage of the land law. Agriculture, which accounts for about 30 percent of GDP, is the only sector that could stimulate growth in the short term. The long-term land lease program, compared with private ownership of the land, does not provide as strong an incentive system as necessary for inducing the required supply response. While we share the authorities' view regarding the complications related to shared resources, the proposal by the World Bank to test land privatization options in pilot areas is worth considering.

Finally, as the staff has correctly pointed out, the success of economic reforms and prospects for high levels of sustainable growth depend crucially on early resolution of the conflict. Azerbaijan, with its rich natural resources, favorable climate, and fertile soil, has great potential for growth and development. In order to actualize the potential benefits this country offers, it is important that a peaceful solution to the conflict be reached soon. A positive response to the authorities' request for technical assistance and for the use of Fund resources, would encourage the authorities to continue their economic reform efforts.

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

Mr. Desruelle made the following statement:

The economic potential of Azerbaijan is large, especially in natural resources development, and this augurs well for the medium term. In the short term, the country is facing severe difficulties. Like other countries in the FSU, it has been affected by large external economic shocks. These shocks have been compounded by the impact of the conflict in Nagorno-Karabakh. It is therefore not surprising, unfortunately, that a large decline in GNP has been observed over the past years.

However, the current economic results cannot all be attributed to political or external factors. The economic policies the authorities followed have played a significant role. For instance, the large fiscal deficit and loose monetary policy have contributed to the persistence of a high inflation rate; strict regulations and requirements on the foreign trade and exchange markets have had a part in discouraging exports and inducing capital flight. Furthermore, some of the policies implemented to remedy difficulties have clearly been counterproductive. I am thinking, for instance, of the expansion of subsidized credits to finance interenterprise arrears, which resulted only in a large accumulation of new arrears.

Consequently, the need for a comprehensive program of economic stabilization and structural reforms is clear. In this respect, I wish to commend the staff for their extensive work with the authorities, as regards both policy advice and technical assistance. This work is certainly essential. Judging from the content of the supplement to the staff report, it appears that these efforts are starting to have a beneficial impact on the authorities' policy design.

The information provided in the supplement to the staff report is indeed encouraging. The modifications of the determination of the official exchange rate, reduction in foreign exchange surrender requirements, and the intent to tighten fiscal policy all go in the right direction. The authorities must be commended for these actions. They are a positive step in the preparation for the postwar period.

Yet, clearly, these recent efforts are only a first step. First, as mentioned in the supplement, the measures identified are not all fully fleshed out; this being particularly true for the budget measures. Second, and more importantly, all the experience of this institution in countries in transition demonstrates that significant progress can only be made if reforms are comprehensive in each policy area and coherent across these areas. To take just two examples of these linkages, a tight fiscal stance must not be undermined by runaway credit; and strong financial policies need to be backed by hard budget constraints.

Consequently, efforts must be pursued to define a comprehensive program. The elements that could form such a program are well covered in the staff report. Obviously, the reduction in inflation and the establishment of a sound currency are priorities. These goals require an effective tightening of fiscal policies; a fundamental reform of monetary policy, comprising abandonment of directed credits and a move to positive real interest rates; imposition of hard budget constraints on public enterprises; and liberalization of trade and exchange markets.

In conclusion, let me welcome the information regarding the progress made on solving the conflict in Nagorno-Karabakh. While making headway in economic reforms is not necessarily dependent on political developments, there is no doubt that significant progress toward a negotiated settlement in this conflict is an essential factor in the prospects for successful implementation of a comprehensive reform program.

The staff representative from the European II Department, responding to questions, observed that, in view of Azerbaijan's present economic circumstances, the authorities were committed to having a market-determined exchange rate, at least in the immediate future. That certainly did not rule out reverting to a currency peg when the conditions were more conducive, for some of the reasons cited by Mr. Kural. In the interim, there were a number of banks authorized to deal in foreign exchange--and those numbers had increased over the past year and a half--but there was no structured framework within which transactions could take place. The staff felt that it was possible to develop in a fairly short time period an interbank market that operated through the Baku interbank currency exchange, where banks would be buying and selling foreign exchange with very little intervention on the part of the central bank. That would develop ultimately into a full-fledged market when some of the infrastructure was in place. Of course, that would take a longer time. But there would be still prospects for once or twice a week to hold such a market and have a market-related exchange rate, and that was the goal toward which the authorities were striving.

The impact of the exchange rate--as determined by the cash market quotations by the banks--on the budget depended very much on the next moves of the authorities, who had not yet formulated their exchange rate policy, the staff representative continued. At present, the rate was still not unified for all transactions. If the arrangements were kept as at present, there would be gains on the revenue side through the implicit taxes generated under the present system. There would also be additions to expenditure, to the extent that, for example, defense was a large component of expenditure, and some of that could be import related. There would be secondary effects of the exchange rate adjustment as other costs increased. The net impact was difficult to gauge, the more so because the reform of the system itself had not really been completed. The impact would be different if a unified system were in place.

On the question of the bread subsidies, when the authorities had raised the price of bread eightfold in November, they had claimed that they had eliminated the bread subsidy, the staff representative noted. What was important was that they had decided to no longer subsidize producers through the budget and they had compensated low- income groups through targeted cash transfers through the Social Protection Fund. In the interim, the cost of bread production had gone up and bread prices had not been readjusted. That, of course, was costly. There were still no transfers through the budget and the authorities were considering another round of adjustment. That was a very sensitive issue because of the large proportion of refugees in the population for whom bread was an important staple product.

Mr. Gaspard made the following statement:

> I agree with the thrust of the staff's recommendations, as outlined in their informative and well-written report. I will limit my remarks to two areas I would like to emphasize. These are the reform of the exchange system and the need to quickly proceed with devising and implementing an effective, well-targeted social safety net.
>
> With regard to the exchange system, I join the staff and previous speakers in their emphasis on the urgency of reforming the exchange and payments system. In this respect, I am encouraged by the recent measures outlined in the supplement to the staff report and in Mr. Kaeser's most helpful statement. Nonetheless, I note the staff's comments on the shortcomings that remain, and urge the authorities to proceed without delay in implementing the staff's recommendations.
>
> As I stated, the second area I wish to address is the need for a well-targeted, cost-effective social safety net. As has been repeatedly demonstrated in other countries undergoing major economic transformation, slippages in the achievement of fiscal targets, particularly through expansionary incomes policies, result mostly from the authorities' attempts at mitigating the impact of rising prices on the living standards of the vulnerable segments of society. The sooner an efficient and cost-effective protection system is put in place, the better positioned are authorities in their effort to stabilize the economy through sufficiently tight fiscal and monetary policies, and the sooner they are prepared to undertake significant structural reform measures. Azerbaijan is no exception. In fact, the problem there is exacerbated by the large number of refugees caused by the

conflict. I would therefore urge the authorities to give this issue the highest priority and to seek, as soon as possible, technical assistance in designing and implementing a more efficient and well-targeted social safety net.

This brings me to a related subject, namely, the format of the budget presentation. Before a meaningful analysis of social expenditures can be undertaken, budget transparency has to be significantly enhanced. I refer in particular to Table 2 in the report, and Tables 18 and 19 in the background paper. While the staff makes a reference in the background paper to the wage bill accounting for over 60 percent of total government expenditure in 1993, this is not readily apparent from the budget tables, where the civil service wage bill seems to be included in the "social and cultural" expenditure item. While I agree that the planned creation of a treasury should bring more efficiency and transparency into budget management, perhaps the staff could shed some light on the technical assistance already being undertaken by the Fund, or that needs to be undertaken, in the area of budget transparency.

In conclusion, Azerbaijan is fortunate to be endowed, as other speakers have noted, with a rich natural resource base that, once the necessary economic reforms are put firmly in place, should attract sizable foreign investment and promote higher growth. This is, of course, predicated on the resolution of the military conflict and the achievement of peace, the prospects for which, we are pleased to hear, have substantially improved. We sincerely hope that a peaceful settlement will be achieved in the near future, and we wish the Azerbaijan authorities all the best in their endeavors.

Mr. Rainford made the following statement:

The severe economic and financial imbalances in Azerbaijan, which were evident when the Executive Board completed the Article IV consultation in March 1993, have worsened and are accompanied by a precipitous decline in real output with no current prospect for a turnaround. Azerbaijan remains in a state of grave crisis, resulting from the combined impact of the Nagorno-Karabakh conflict and the disruption of payments flows with the other FSU states. The authorities still await the fundamental preconditions necessary for embarking upon meaningful and comprehensive reform, namely the abatement of destabilizing conflict. It is to be hoped that a new cease-fire agreement will emerge early, following the violation of the cease-fire arranged on May 16.

In light of the prevailing conditions, the authorities are to be commended for persevering with efforts to implement elements of reform. It is regrettable that force majeure conditions appear to be preventing them from establishing a track record of stabilization, so that they may enter into a suitable arrangement enabling them to access Fund resources under an appropriate program. It will be recalled that Moldova found it possible to secure progress in some areas of reform, notwithstanding the problem in the Transnistria region; perhaps Azerbaijan can take some comfort from this, though the two cases differ.

The Azerbaijani authorities are therefore encouraged, even in the face of their dissipating energy in the prevailing unrest, to persist with the reforms that can be implemented for the time being, as this will put them that much farther ahead when conditions become more propitious.

Naturally, basic stabilization is the first order of business to which reform efforts must be addressed, and here fiscal reform is of central importance. It is encouraging that the projected increase of the fiscal deficit to 12.2 percent of GDP will now, according to the staff report supplement, be replaced by a narrowing of the deficit to a probable 5.7 percent of GDP, or possibly 1.8 percent, if the ambitious revenue measures of the authorities are achieved. However, even if the less ambitious outcome for the deficit materializes, it would represent a substantial movement for the better in the fiscal picture.

If this level of reduction can be achieved while the Nagorno-Karabakh conflict is going on, the authorities should be well placed to move quickly toward further fiscal containment when the conflict ceases, as outlays on defense and security, which now exceed 25 percent of expenditure, could be substantially reduced. In this scenario, it could be possible to increase outlays for capital expenditure and social services while narrowing the deficit.

One question arises concerning plans for financing the deficit. The main staff report indicates an intention to use privatization proceeds, among other means, to finance the deficit. It struck me that, if at all possible, the authorities should avoid using privatization proceeds in this way. It appears from the supplement that privatization proceeds will no longer be used to finance the deficit, though it is a matter of some concern that ANB credit will be used for this purpose. I would welcome clarification of the outlook for deficit financing.

The establishment of the ANB, to which the Fund has provided technical assistance, was a positive move, along with other measures such as the setting up the treasury, toward equipping Azerbaijan with the institutional capacity to manage financial and economic affairs. It is therefore regrettable that the ANB now seems to be in the process of being marginalized, as it has not been given any effective supervisory powers over the banking system, and is also being left out of the management of the exchange system. Could the staff explain where the ANB stands in the present order of things, and what really is its eventual fate as a central bank?

Azerbaijan will, in all likelihood, have to face difficult times before seeing light at the end of the tunnel. The authorities have no option but to keep moving toward this light, if their long-run aspirations for stable, sustained growth are to be realized. The Fund and the other international agencies should remain with Azerbaijan in the struggle to stabilize conditions, and I wish the authorities well in their continued efforts.

Mr. Barr made the following statement:

I can agree with the staff analysis, especially the very mixed results in containing the macroeconomic imbalances over the past 18 months. I can therefore welcome Mr. Kaeser's statement, and that in the staff supplement, of the authorities' commitment in principle to a much more ambitious reform program. I recognize, of course, that the conflict has checkered the reform process so far, but nevertheless, as Mr. Desruelle has said, policies have not helped and the reform effort needs to be accelerated across all fronts.

Progress has been slow, with the authorities generally perceived as having strengthened state control in a number of respects. There has also been a tendency to see development of the oil sector as a substitute for market reform rather than as a complement. I think this is clearly nonviable, as the foreign direct investment in this sector is likely to be considerably enhanced by stable macroeconomic conditions. I was therefore able to welcome the authorities' intention to seek Fund support once a peace settlement is agreed.

The fiscal position remains a major concern, especially given the clear risk of a further deterioration as a result of conflict. I welcome the additional revenue measures being considered but it was unclear in Mr. Kaeser's opening statement whether these would reduce the deficit to below 5.7 percent of GDP. I would be grateful for some clarification on this point. The understandable commitment to social protection in the present circumstances is exacerbating the fiscal position, and there is a need for much greater targeting of the social safety net.

I welcome the planned measures to tighten monetary policy. However, the impact of such tightening may be blunted if the arrears problem is not also simultaneously addressed through measures to enforce greater financial discipline on enterprises. The extent to which credit policy is driven by subsidized, directed credits is a particular concern. This demonstrates that little progress has been made either in establishing a clearly delineated two-tier banking system or in developing the Azerbaijan National Bank's central banking functions. As long as this is the case, Azerbaijan's institutional capacity to turn an effective counterinflationary policy is open to serious doubt.

In addition, there is an urgent need for structural reform to be accelerated if a market economy is to take root; the old central planning regime needs to be quickly dismantled, moving away from the state order system and partial price liberalization, which crowds out new private suppliers, and obstructs market signals. Privatization plans should be much more ambitious. Bankruptcy legislation, together with firm implementing arrangements, should be a priority.

However, there are some recent positive indications of commitment to market principles, most important, the free floating of the exchange rate on May 24. This is one--but one very important--step toward a fully market-oriented economy.

In conclusion, Azerbaijan faces very difficult challenges, including all those facing other countries of the former Soviet Union--and more, owing to the impact of the war. It is clear that while faster progress could, and should, be made on the reform path, resolution of the conflict is needed to expedite the reform agenda.

Mr. Lvin made the following statement:

It has become a good tradition in this institution to combine transitional countries' Article IV consultations with either adoption or review of some kind of financial assistance program. However, there is no such program in the case of the Azerbaijan Republic. This reflects, of course, the slow advance in economic reform. Certainly, ongoing hostilities should be regarded as a primary reason for not having such a program. However, the authorities' economic policy ought to bear its share of responsibility as well.

The staff papers provide us with ample evidence that the authorities are lagging well behind most of the other FSU countries. Their approach to the introduction of a full-fledged national currency may serve as a good indicator of progress, as was the case with other FSU countries over the last year. Such an introduction in Azerbaijan has been marked by repeated delays and postponements, gradualism, and indecisiveness.

It is sufficient to point to the continuing and mounting wage arrears caused by the shortage of printed cash. This phenomenon was common to many FSU countries, not excluding my own, about two years ago, but I was surprised to see it still in place in Azerbaijan. Arrears have reached about 20 billion manat, which is close to half of the end-December level of currency in circulation. These arrears alone may have distorted the economic overview, making real wages artificially higher and the inflation rate lower than it should be.

I was no less surprised to learn from the staff paper that an obsolete mechanism of MFO, or interbranch circulation, has been in place until recently. This mechanism, quite effective in containing open inflation under the monobank system, proved an extremely effective instrument of decentralized and uncontrolled money creation when former branches of monobank began to gain some degree of independence. In view of this, I believe that figures of fiscal outcomes in 1993 are losing their relevance with respect to financial stabilization. Cheap and unchecked credit, along with huge interenterprise arrears, which were caused partly by a policy of across-the-board bailout, enabled economic agents to create, in fact, their own liquidity.

The weak fiscal and monetary performance has been aggravated by the slow pace of reform at the enterprise level. There is no need to reiterate all areas of continued extensive state interference in the enterprise activities, as they are clearly displayed and assessed by the staff. Should more freedom in wage-setting, price and output determination, and foreign trade activity have, been given to enterprises, one would expect the economy to be bottoming out already and recovery commencing.

However, some steps undertaken by the authorities recently look rather encouraging: streamlining bank supervision; termination of the MFU system, which is planned to take place July 1; and modification of surrender regulations. These steps could and should be augmented by such urgent measures as abolishing widespread state procurement orders, or termination of differential treatment of different exports with respect to price, quota regulations, and surrender requirements--accompanied, perhaps, by the introduction of some product-specified tax measures.

The Nagorno-Karabakh conflict has often been mentioned as a source of heavy suffering and economic distortions. It is widely known that my authorities are doing their best to facilitate a peaceful settlement of the conflict. Therefore, I see clear prospects of Azerbaijan having a well-prepared program which might be supported by this institution. In this regard, the issue of ESAF-eligibility should be addressed promptly and positively.

With these remarks, I hope for substantial progress in the transformation of Azerbaijan's economy.

The staff representative from the European II Department observed that, as Mr. Gaspard had rightly pointed out, the budget was not an economic classification and, hence, not as analytically useful even as a guide for policy as it would be otherwise. Work on the presentation of the budget had been initiated. Two technical assistance missions from the Statistics Department had been helping to move the budget toward an economic classification. The setting up of the new treasury should facilitate the process.

On the financing of the fiscal deficit, the staff representative noted that, in a sense, it was academic whether, in fact, privatization proceeds would be used as intended, or whether, in their absence, the gap would be made up by further borrowing from the National Bank because the authorities had not yet approved the privatization program for the current year. They had presented it to Parliament, but Parliament had turned it back with requests for further revisions. Hence, it was highly unlikely that much revenue would be generated from privatization. Unless additional revenue measures or expenditure-curtailing measures were put in place, it was conceivable that there would be higher borrowing from the National Bank to make up the difference.

He agreed with Mr. Rainford that it would be very difficult for adjustment to take place until the conflict was resolved, given the tremendous demands on resources generated by the conflict. Nonetheless, the authorities had shown tremendous willingness and commitment to reforms, and that should be encouraged. Any reform program that was drawn up while the conflict was still ongoing obviously had to take that very much into account. In some ways, the adjustment would have to be tighter in other areas to compensate for the costs of the conflict.

On the future role for the National Bank, the staff representative commented that the National Bank was a very new institution. Certainly it was not a true independent central bank in the Fund's understanding of that concept. There had, moreover, been frequent changes in the management of the central bank. Therefore, the reforms there had been slower than one might have hoped. But, it was a learning process, and the intention again was to have a bank that did influence policy making, that did guide the economy; and the authorities were moving toward that goal. The staff believed that there was also scope for much better cooperation by the central bank in the reform effort with the recent change in its management.

Mr. Barr, alluding to Mr. Kaeser's statement, had raised a question of the 5.7 percent deficit, the staff representative recalled. That was the deficit before the measures; hence, if the measures were added in, and if they generated the types of revenues that the authorities were envisaging, the deficit would be lower than 5.7 percent. Finally, on STF eligibility, the staff's very tentative calculations indicated that, on the basis of export shortfalls, Azerbaijan would be eligible for an STF drawing.

Mr. Lvin remarked that he had been speaking about ESAF eligibility, not STF eligibility.

The staff representative from the European II Department noted that Azerbaijan did not qualify for ESAF resources. It was just at the cut-off point.

The staff representative from the Policy Development and Review Department indicated that the staff would be willing to look at the whole issue once again, based on the latest figures.

The Chairman suggested that the staff not make a final decision on the matter, in view of the problems of assessing the real consequences of the war on the economy, on its true size, and on what could be the views of the World Bank with respect to IDA eligibility.

Mr. Kaeser made the following concluding remarks:

> As the questions raised by the Board have been answered by the staff, I can be brief.
>
> I would like to thank my colleagues for the discussion on the economic situation and policies of Azerbaijan, and especially for understanding the special circumstances prevailing in this country. I will convey to the Azerbaijani authorities the encouragements, as well as the comments and concerns of the Board.
>
> I took notice of the Board's recommendations regarding macroeconomic policies--fiscal prudence and monetary discipline--and its appeal to the Azerbaijani authorities to establish a social safety net, improve the structure and functioning of the foreign exchange market, extend the role of the central bank in the surveillance of the banking system, and to accelerate the pace of privatization. We can take for granted that the present volatility of the exchange rate will force the authorities to improve the foreign exchange market along the lines proposed by the staff. The change at the head of the NBA will make it easier to give more responsibilities to this institution. The Board also questioned the slow pace of the privatization process. The Government of Azerbaijan remains firmly committed to make headway on this issue. The first experiences in the privatization of agricultural enterprises, for example, have been very successful, as the productivity of the private farms did rise quickly, to three times that of state farms. But one has to take into consideration that privatization is not easy to carry out in an

orderly fashion in a country at war. If social unrest is to be prevented, privatization should not take the form of a sell-off of state assets to war profiteers. What is of paramount importance is first to force state enterprises to behave like private ones, by putting them under hard budgetary and legal constraints. This can be done by rescinding budgetary subsidies, streamlining the monetary policy, and passing a bankruptcy law. This is precisely what the Azerbaijani authorities are ready to do.

I think that everybody in this room understands that the future of Azerbaijan depends to a large extent on settlement of the Nagorno-Karabakh conflict. This settlement would free Azerbaijan of the huge burden of war. It would allow the mobilization of international community support to repair the immense damage caused by the war, and to reap the fruit of Azerbaijan's rich industrial and agricultural potential. The authorities, as stated in the letter of the President to the Managing Director, are fully aware of the fact that they have to follow a strict economic policy and reform the structures of the economy if they wish to secure economic growth, benefit from the support of the international community, and to attract private foreign investors. They have already taken in recent weeks, a range of measures all heading in the right direction. I would like to mention that they submitted to the Parliament for approval monetary policy guidelines, which are in line with the recommendations of the Fund. Therefore, they should get the help of the Fund in shaping a comprehensive reform program so they may draw on the STF as soon as the peace settlement enters into force.

The Azerbaijani authorities would welcome the publication of the background paper, provided that the recent developments are taken into account.

They would like me to convey to the Fund their gratitude for the technical assistance given to them. However, their needs in this respect remain very large. I observed that the technical assistance, slowly but surely, brings about in the mind of the decision makers and administration the revolution which is necessary to lead to deep-rooted reform.

The Azerbaijani authorities also thank the staff and the resident representative for their work and the good advice provided to them.

The Chairman made the following summing up:

Executive Directors were in general agreement with the views expressed in the staff report for the 1994 Article IV consultation with Azerbaijan. Directors recognized that the preoccupation with the war waged on its territory, and the diversion of sizable human and financial resources to the conflict and refugee-related activities constrained Azerbaijan's reform effort. They expressed the hope that a peaceful settlement to the conflict could be reached soon, to allow Azerbaijan to realize its considerable economic potential.

Directors welcomed Azerbaijan's introduction of a national currency, the manat. They noted that the success of stabilization efforts to support the manat would be contingent on strengthened monetary discipline, underpinned by prudent fiscal and incomes policies. Directors urged the authorities to implement, without further delay, a monetary and credit program aimed at reducing the rate of inflation. Speakers expressed concern about the continued highly negative real interest rate structure, and they encouraged the authorities to further raise interest rates, initiate auctions for the allocation of Azerbaijan National Bank credit, and eliminate subsidized lending. The restoration of monetary stability would require the containment of central bank financing of the Government and of state enterprises. Progress in this area would need to include steps to avoid the recurrence of enterprise arrears.

Directors noted the authorities' fiscal objective of strictly containing the budget deficit through revenue measures and expenditure savings. In particular, measures were needed to broaden the tax base and streamline government expenditure, including through reductions in public service personnel. Directors encouraged the authorities to secure prompt approval of the necessary fiscal measures to contain the budget deficit within the objective for the year. Directors underscored the necessary contribution of a restrained forward-looking income policy, combined with a well-targeted social safety net, to the success of efforts to contain the fiscal deficit. They noted the importance of developing a treasury system within the Ministry of Finance and monitoring budgetary developments closely with a view to narrowly limiting government recourse to bank credit.

While welcoming the recent reduction of surrender requirements and a shift toward market determination of the exchange rate, Directors urged the authorities to further simplify and decentralize exchange and trade arrangements, and in particular to develop an interbank foreign exchange market that would provide a more comprehensive indicator for the exchange rate. Unification of the exchange system would be the next crucial step.

Directors urged the authorities to step up efforts in the area of structural and institutional reforms, especially the more ambitious and vigorous implementation of a privatization program. They acknowledged the importance of simultaneously restructuring state-owned enterprises that hold promise of being viable, and liquidating those that are in need of sustained financial support. The adoption of a bankruptcy law would facilitate this process. Directors welcomed the progress in price liberalization and the removal of food subsidies, but they stressed that a further alignment with world prices, particularly for energy products, should constitute an important element of structural reforms. Steps should also be taken to move forward with reforms of the banking sector, including the legal and regulatory framework for commercial banking.

More generally, Directors encouraged the authorities to accelerate the work on improving institutional capacity and the data base by implementing the key recommendations of the Fund's past technical assistance missions in the fiscal, banking, and statistical areas. They expressed their support for the continued close policy dialogue between the Fund and Azerbaijan, and the provision of further technical assistance.

In sum, Directors agreed that to the extent possible, the Azerbaijan authorities should prepare the institutional and policy framework of the economy for its postwar phase. However, Directors had to conclude with great concern that current economic policies--under the impact of the war--were increasing the distortions in the economy and were becoming unsustainable. The role of the state in the economy remains dominant, and progress with structural reforms has been slow. Fiscal and monetary imbalances continue to grow, and exchange rate policy is distorted. Directors expressed the hope that the restoration of peace would permit Azerbaijan to start realizing its enormous economic potential.

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

The Executive Board took the following decision:

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

2. Azerbaijan maintains multiple currency practices and restrictions on payments and transfers for current international transactions, described in SM/94/128, in accordance with Article XIV, Section 2, except for the multiple currency practice arising from Azerbaijan's multiple exchange rate system which is subject to approval under Article VIII. The Fund encourages Azerbaijan to eliminate the exchange measures maintained under

Article XIV, Section 2, as soon as its balance of payments position permits, and urges Azerbaijan to eliminate the multiple currency practice which is subject to approval under Article VIII as soon as possible.

Decision No. 10707-(94/52), adopted June 8, 1994

7. NAMIBIA - 1994 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1994 Article IV consultation with Namibia (SM/94/109, 5/3/94). They also had before them a statistical appendix (SM/94/113, 5/6/94).

The staff representative from the African Department made the following statement:

The latest revised 1993/94 budget outturn information received since the issuance of the staff report on Namibia indicates that the deficit including grants for 1993/94 is now estimated at N$ 392 million, an equivalent of 4.6 percent of GDP, a little below the estimate shown in the staff report of N$ 409 million, or an equivalent of 4.8 percent of GDP. The source for the low estimate for the deficit is primarily better-than-expected revenue performance. The estimate for total expenditure is virtually unchanged.

The 1994/95 budget has been approved by the National Assembly on April 21, as outlined in the staff report. According to available information, budget implementation has remained on course.

The World Bank's public expenditure review mission, originally planned for May 15 to June 16, 1994, has been rescheduled and will now take place during the period June 15 to July 20, 1994.

Mr. Dlamini made the following statement:

My Namibian authorities believe that the staff report provides a fair representation of the recent developments in their economy and are, therefore, in broad agreement with the main thrust of the staff appraisal. They are also grateful to the Fund and other international organizations for the technical assistance provided in support of their efforts at improving macroeconomic management capacity.

At its independence in 1990, Namibia inherited an economy that was heavily dependent on the mining sector. Economic performance has, therefore, largely reflected this dependence. For example, while the economy grew by 5.6 percent in 1991-92 when the performance of the mining sector was satisfactory, the growth rate fell to an estimated 3.3 percent only in 1993 following weak performance by the mining industry. Some improvement is expected in 1994.

Namibia also inherited other problems that are of concern to the authorities. These include gross social and economic disparities, serious shortages of skilled manpower, weak administrative structures and high unemployment. With regard to the latter, the situation is compounded by the existing structure of wages inherited from the past, in which wages relate more to the South African rather than to the domestic economy.

The authorities give priority to the resolution of these problems. In particular, they wish to reduce the social and economic disparities, increase the stock of skilled manpower available in the country, strengthen administrative structures, and create conditions which will lead to the creation of more employment opportunities. Already, some progress has been achieved in strengthening administrative structures, institution building, and in creating the capacity for macroeconomic management.

In their efforts to deal with the continuing challenges, the authorities recognize that prudent financial management is essential to sustained growth over the medium term. They realize that only a growing economy can help resolve the deep-seated social and economic disparities.

In line with this policy, the authorities, while increasing expenditure on health, education, and training, are seeking to contain the pressures on expenditure, which have become evident in recent years. Accordingly, the 1994/95 budget aims at reducing the deficit--including grants--to 4.4 percent of GDP from 4.8 percent in 1993/94 by cutting total expenditure from 41 percent of GDP to 39 percent. It is the intention of the authorities to reduce the deficit further, in order to stabilize the economy and contain the expansion of the public debt. In doing this, they will place an emphasis on reducing expenditures in the context of the public expenditure review that is being carried out with the support of the World Bank.

Already, the authorities have announced a number of measures aimed at reducing expenditure. First, the 1994/95 budget contains no provision for a salary increase. Second, the authorities have adopted a policy of downsizing the public service through organizational and staff rationalization, a freeze on certain appointments, and an early retirement scheme. At the same time, they have, with the support of the Fund and the UNDP, made progress in developing a mechanism for expenditure monitoring and control, streamlined the payment and revenue cycles, and standardized financial documentation.

The authorities are concerned about the revenue outlook in the near and medium terms. This is because of the uncertainties relating to SACU receipts which amount to 10 percent of GDP or 25 percent of government revenue. The authorities are considering ways of broadening the revenue base.

In the area of monetary policy, Namibia is a member of the Common Monetary Area and cannot, therefore, conduct an independent monetary policy. Nevertheless, it has made considerable progress in developing financial instruments. For example, treasury bills and government stocks have been issued regularly since May 1991 and October 1993, respectively, and the Namibian Stock Exchange has been in operation since October 1992. In September 1993, Namibia introduced its own currency to run at par with the South African rand until the latter is eventually withdrawn from circulation. The Government's commitment to a restrained macroeconomic framework should help promote public confidence in the new currency. Namibia's inflation performance is closely related to that of South Africa, which the country depends on as a trading partner.

Owing to a pre-independence decade of low investment and economic growth and the narrow base of its economy, Namibia inherited daunting developmental problems. However, since independence, government policy has aimed at promoting private sector investment as a vehicle for long-term growth and employment creation. To this end, the authorities have, over the last three years, implemented a number of measures aimed at encouraging private investment, including substantial tax incentives to manufacturers. Moreover, the Pension Funds Amendment Act was recently enacted to encourage investment in Namibia of part of the available pension funds that previously were invested in South Africa.

In view of the slow pace of the economy's growth over the past several years, the authorities intend to take measures aimed at revitalizing it. In this regard, they plan to launch next year a medium-term development plan, which will shift the focus of policy response from the short to the medium term. In connection with this strategy, the Government hopes to strengthen capacity for project generation and implementation.

Namibia's reliance on a narrow range of export commodities and its heavy import dependence make its economy highly vulnerable to exogenous shocks, including the volatility of the terms of trade. Cognizant of these factors, the authorities are directing their efforts toward expanding and diversifying the export base. In particular, besides strengthening mining sector capacity, they intend to exploit the considerable potential in the fisheries, tourism, and manufacturing sectors. The authorities firmly believe that the future growth of the economy depends on a generation of greater dynamism in the export sector, led by increased private sector participation.

As the staff has rightly recognized, the constraints facing the country will take time to resolve. Although the authorities are fully committed to the stabilization and reform of the economy based on free market principles, the degree of success will depend considerably on external support. The continuation of technical assistance from the Fund and other international organizations will be necessary.

Mr. von Kleist made the following statement:

We are in broad agreement with the staff's assessment of the situation in Namibia. Contrary to the staff appraisal, however, I would like to first focus on the positive aspects of Namibia's performance since independence, before dealing with the more problematic issues.

As the staff rightly notes, Namibia's physical infrastructure is well developed, key sectors of the economy are well managed and the political leadership is committed to pragmatic economic and social policies, multiparty democracy, ethnic and social reconciliation, and effective measures to strengthen economic management and the role of the private sector. Those are impressive assets, especially for a country in otherwise much troubled sub-Saharan Africa. We especially want to commend the authorities for their pragmatic approach toward solving the difficult challenges inherited from the past, namely, large social and economic inequalities and high levels of unemployment. The Namibian Government need only to look over its Eastern border to Botswana, to find a role model for the difficult path ahead.

The ongoing changes in South Africa, with the accompanying uncertainties, the seemingly never-ending civil war in its Northern neighbor, Angola, and ongoing economic difficulties in Zambia and Zimbabwe, to whom Namibia is connected via the Caprivi strip, add up to significant regional uncertainty, and the loss of a potentially powerful regional economic upswing.

The key ingredient for a bright economic future is Namibia's low level of public debt, especially foreign debt. This gives the authorities room to maneuver within a budget of which other governments burdened with high interest payments can only dream. Considering the erratic nature of tax receipts from the mining sector and uncertainty about future receipts from SACU, the Government should indeed focus on restraining expenditures and establishing priorities by redirecting funds within existing budgetary limits. In this context, we welcome the detailed expenditure analysis that will be conducted with the assistance of the World Bank. There also should be some scope for reducing the bloated public sector wage bill. Quite apart from any fiscal considerations, such a move would increase the political credibility of the Government. We further support the Fund's advice of shifting from the current sales tax to a value-added tax.

As in so many other countries, unemployment, especially among the urban youth, is worrisome. The close link between Namibian and South African wages, which does not cater to Namibia's vastly different structure, seems to be one of the main problems. High wages, paired with closed-shop union strategies could render the highly praiseworthy engagement of the authorities in the educational sector obsolete. We commend the authorities for this engagement in education; it is not often found that a country spends nearly five times as much on education as on defense.

Domestic savings are another weak point in Namibia's economic structure. Maybe the staff could elaborate on the magnitude of capital outflows by the insurance industry and the pension funds. Did the staff suggest any additional measures to encourage these institutions to invest a larger share of their portfolio domestically, and how does the staff assess the Pension Funds Amendment Act? An additional supply of private capital, in conjunction with fiscal restraint by the Government, would be a first step toward raising investment to a level consistent with sustaining growth in output and employment adequate to meet the needs of a rapidly growing population. Additional measures to curb this rapid population growth would also help to improve economic conditions for the population as a whole.

Namibia has so far fared remarkably well, and the authorities have made wise policy decisions. As the date of independence increasingly becomes history, the Government must assume full responsibility and control of the nation's present and future. We urge the authorities to take full advantage of the comparatively good economic and political foundations to make sure that this future is indeed a bright one for the Namibian people.

Ms. Brettschneider made the following statement:

The generally positive trends we saw in Namibia's macroeconomic management in the two years following independence are becoming clouded by a number of warning signs--a significant budget deficit stemming from both declining revenues and increased expenditure pressures, and a low but quickly rising debt burden. Moreover, after experiencing GDP growth of 5.6 percent in both 1991 and 1992, growth contracted by a disturbing 3.3 percent in 1993. Output is, however, expected to rebound somewhat this year.

The staff report illustrates clearly that the centerpiece of the authorities' economic policy package must be fiscal consolidation. The Government's increasing borrowing requirements strain budget resources, stifle investment, and dampen growth prospects. Ensuring sustained high growth over the medium term will require the authorities to reduce government competition with the private sector and free up resources for increased investment by correcting fiscal imbalances.

The staff recommendations on fiscal policy appear to be on target. On the revenue side, the uncertainty surrounding future SACU arrangements--the proceeds of which account for over 25 percent of government revenues--will require the authorities to identify alternative revenue sources. With tax ratios already high, broadening the tax base and developing new non-tax revenue sources will be crucial. We encourage the authorities to plan ahead in this area.

However, the rather limited scope for revenue increases and the already large share of government spending in GDP call for a priority on expenditure containment. While increased social expenditures after independence were expected, in view of the wide social inequalities in Namibia, fiscal constraints require better prioritization of such expenditures and improved cost recovery efforts. As this chair noted at last year's review, the spending patterns now being developed appear to be outstripping the economy's capacity to provide real resources to pay for the additional expenditure, without crimping Namibia's medium-term growth capacity. In the end, reducing social inequalities will be easier with "a growing pie." The authorities' recognition of this is encouraging.

Against this background, we would have hoped to see a more ambitious approach to expenditure reduction than is envisioned in the 1994/95 budget. Current expenditure, though slightly reduced, is projected to absorb almost 34 percent of GDP, with the civil service wage bill alone accounting for over half of that amount. While we find it promising that the authorities appear to be holding the line on civil service wages for the time being, more will clearly be needed to address the budget burden of an overly large and relatively highly paid civil service.

The fiscal deficit was financed by drawing down government deposits and a heavy issuance of treasury bills, which lead to the rapid growth of central government debt, albeit from a low base. As Mr. von Kleist has pointed out, Namibia is still in an enviable position of relatively low debt, where resources can be applied to building a better future, rather than to servicing past obligations. At the same time, Table 24 of the statistical appendix illustrates that the rising level of domestic debt threatens to undermine the debt profile, if left unchecked. Closer at hand are the repercussions for investment, stemming from the Government's absorption of domestic resources. Specifically, tighter liquidity and rising real borrowing rates discourage the investment needed to stimulate job and output growth.

We would underscore as well the point made in the staff report on page 18, namely, that a sustained budget deficit could weaken the external accounts and undermine the stability of the Namibian dollar. The recent introduction of the national currency has gone off well, with the currency board arrangement providing for full backing by the rand. This arrangement could be put at risk if growing budget deficits create pressures for the monetization of government borrowing. We would welcome the staff's views.

The unemployment problem has continued to deteriorate, with the jobless rate rising to almost 27 percent in 1993, and urban unemployment registering over 35 percent. Unemployment is expected to worsen this year. The staff's recommendations on unemployment, which focus on encouraging private sector growth to absorb labor and maintaining competitiveness through wage restraint, make sense. Faster investment growth is essential in this regard, which highlights, once again, the need for the authorities to avert crowding out by maintaining maximum prudence in debt management and ensuring that fiscal pressures do not lead to unsustainable debt accumulation.

On the external side, Namibia's balance of payments continues to look pretty good, although still vulnerable to outside shocks, in view of the heavy dependence on the mining sector. Expansion of the export base will be key to reducing exposure to commodity price fluctuations, and we were glad to learn that the authorities have made this a priority. The recent transfer of Walvis Bay to Namibian control and the development of new transit networks to the interior open up new opportunities to Namibia as a regional trade center. We would welcome the staff's views on the potential economic impact of the Walvis Bay transfer.

Ms. Srejber made the following statement:

I would like to thank the staff for a well-prepared and thorough analysis of Namibia's economic situation and outlook. As I broadly agree with the recommendations of the staff, I would only like to focus on two particular points. The first one is economic balance, and the second one is the importance of strengthening the basis for private sector activity. As I represent a constituency with many small countries, some of which have also recently regained their independence, I feel we have some understanding of the problems facing countries such as Namibia. Moreover, Namibia and the Nordic countries have long-standing special relationships.

The economic balance in Namibia has been satisfactory so far. There are, however, as pointed out by other speakers, some warning signs that should be noted. The rate of inflation has remained stubbornly high, and the fiscal deficit has continued to deteriorate for some years, with the exception of a small, but of course welcome, improvement last year. I am especially concerned about the poor fiscal balance, which is the key factor for the credibility of economic policy.

Hence, I welcome the authorities' intention, expressed in Mr. Dlamini's statement, to reduce the budget deficit further, primarily by reducing expenditure. I would like to emphasize the need for the Namibian authorities to cut expenditures more than outlined by the authorities' current plans, in order to quickly strengthen the fiscal balance. According to the staff analysis, the primary balance deficit--including grants--will remain on an unsustainable level for several years to come. Curbing public expenditures, in order to strengthen public finances, seems to me a better alternative than increasing taxes, because, as the staff points out, the tax burden in Namibia is relatively high. Moreover, as the staff also points out, there is a substantial uncertainty in the Southern African Customs Union revenue outlook.

On the expenditure side, there is an apparent need to rationalize the exceptionally large public administration. This would, in turn, allow the Government to decrease the civil servant wage bill, which is now excessively high.

If the fiscal situation cannot be consolidated, I am afraid that the credibility of economic policy will begin to suffer. This has a negative impact on inflation, and on the stability of exchange rates. The imbalance would eventually lead to problems in external financing.

Let me now turn to my second point, the strengthening of private sector activity. As the staff points out, the private sector in Namibia is quite undeveloped. Building and strengthening the private sector is more time consuming than reaching a fiscal balance, although limiting public sector growth will also simultaneously give more room for the private sector. Establishing proper conditions for a smoothly functioning export-oriented private sector is the main long-term task for Namibia. Only an economically sound private sector can create a sufficient number of permanent jobs, which can absorb the rapidly growing labor force.

Creating a legislative framework and building the necessary institutions is one part of the long-term task of fostering the private sector. This is an important part in building an infrastructure, which could form a framework within which a private sector can progress. Even if the physical infrastructure is relatively well developed in Namibia, there is room for improvement. Because infrastructure investments will only yield indirect results over the long term, the public authorities are the proper body for taking care of infrastructure building. Public expenditures should accordingly be reallocated toward these investments. The Namibian authorities should direct more effort to infrastructure building in the broad meaning of the word.

Ms. Langdon made the following statement:

The Namibian authorities, still in the early years of their national independence, face the challenge of inculcating the habits of good stewardship of their economy, and avoiding the consolidation of entrenched behavior patterns that engender domestic and external imbalances. Accordingly, it is encouraging that the authorities seem to be making some effort already, toward laying the foundation in Namibia for sustainable growth in the years ahead. The overall situation nevertheless appears to be precariously balanced, as described in the staff report, and will require perseverance and strong determination on the part of the authorities to stick to a path of prudent policies.

The basic challenge arises in the area of fiscal management. I agree with the staff that with the ratio of revenue to GDP already at a projected 34.5 percent for 1994/95, almost the only option available for meaningful reduction of the prevailing budget deficit is the reduction of expenditure. Indeed, expenditure containment may need to be stronger than what the authorities contemplate, as the projected reduction of the government deficit from 4.4 percent of GDP in 1993/94 to 3.0 percent of GDP in 1996/97 seems insufficient to guarantee the conditions required for strong sustainable growth that is based on investor confidence and anchored to an increasingly strong external position.

It is understood that the task will not be easy. The authorities must work toward a greater narrowing of the overall deficit, while seeking at the same time to go from a negative to a substantial positive primary balance, and simultaneously maintain social outlays--perhaps with improved targeting.

Such objectives inevitably point to the public sector wage bill, which stands in excess of 50.0 percent of current expenditure, as a principal item for reduction. I agree with the staff that the restructuring and containment of the fiscal position would require the authorities to go beyond the freeze they are maintaining on public sector wage increases, and implement a reduction in the overall size of the public service. Presumably, the World Bank assisted expenditure review that is now in progress will also address the downsizing of the public service, and if so, I hope careful attention will be addressed to qualitative issues of rationalization of functions and training to enhance the capacity of the reduced civil service.

Strong fiscal consolidation would be an essential part of the strategy to increase domestic saving and restore the level of domestic investment, which stood at 9.6 percent of GDP in 1993, down from nearly 20.0 percent in 1991. With the external terms of trade for diamonds favorable for the moment, and contributing substantially, along with other categories of exports and transfers, to the strengthening of the external position, the authorities need to take full advantage of the breathing space this provides to encourage increased investment that will diversify the economy. I support the suggestion of the staff that all this needs to be put within the context of a well conceived medium-term policy framework, and urge the authorities to avail themselves of Fund advice for this purpose.

It appears the authorities have sought to draw as much benefit as possible from the Fund/UNDP technical assistance program aimed at improving their capacity for macroeconomic management. Achievement of the critical medium to long term objectives of the Namibian economy would seem to call for the maintenance of this support in the near term. I endorse the continuation of this and even greater assistance, and wish the authorities well in their future efforts.

Mr. Yang made the following statement:

Since independence in 1990, Namibia has, with the assistance of the Fund, the World Bank, and the UNDP, made strides in building up its institutional and technical management capacity. Progress has also been made in the financial system, as reflected in the establishment of the central bank and the successful issuance of the national currency. However, the economy, after two years of encouraging growth at more than 5 percent a year, dived to -3.3 percent in 1993, as a result of the drought and the deteriorating performance of the diamond mining sector.

I agree with the staff that in the face of uncertainties surrounding the near-term and medium-term outlook, it is necessary for the authorities to pursue a very prudent fiscal stance. The staff has presented clearly the reasons why such a stance is required, the expected benefits, and the various called-for policy measures. We are pleased to note that a consensus has been reached with the authorities on many of these points. Therefore, I will only make a few general comments for emphasis.

First, it is of critical importance for the Namibian authorities to pursue a tight fiscal stance in order to obtain fiscal sustainability. The budget is faced, on the one hand, with limited scope for revenue increase and, on the other, with severe pressure arising from the need to redress the inherited social inequalities, leaving aside the need for investment and growth. Under these difficult circumstances, the authorities are urged to strive for a better than projected revenue performance through intensifying tax collection and other revenue enhancement measures. On the expenditure side, we are pleased to note that the authorities are ready to scrutinize every item of public expenditure. Apart from this expenditure control system, measures to restrain and reduce expenditures, to a great extent, are curbing public sector employment and restricting pay increases and other overall management measures as the staff recommended. The staff has also spoken of the policy measures the authorities have adopted along these lines. The last staff report stated that the authorities had issued directives "to all line ministries to immediately freeze public employment and to rationalize existing manpower resources with the aim of reducing the size of the civil service." I will be glad to hear what progress has been made in this direction.

Second, to revive the economy and address the unemployment issue speedily, there is a pressing need for substantial investment. As this year's fiscal deficit is already an unsustainable 4.4 percent of GDP and there is virtually no room to increase revenue under the existing conditions, the best the authorities can do is to invest their limited and precious resources in the priority projects, including the most urgent social programs, and to press ahead with improving investment efficiency. The Government's policy to encourage the private sector along these lines is correct, and the authorities are encouraged to stimulate foreign investment through extending a similar policy.

In view of the well-developed infrastructure and the endowment of rich natural resources, what needs to be done to create an environment conducive to private sector and foreign investment is to put in place a set of policies formulated on the basis of Namibia's actual circumstances.

As for the sectors that may be targeted for such investment, these are, in my view, manufacturing, processing, and agriculture, with small-scale manufacturing and processing at the center. In view of their insignificant shares of about 7 and 5.8 percent, respectively, in the 1993 GDP and total employment, manufacturing and processing should have a wide scope and very promising prospects for expansion, as well as being economically worthwhile, bearing in mind the effect of their added value.

Finally, we support the authorities' plan for next year to launch a medium-term development plan in order to address the slow pace of economic growth over the past several years.

With these remarks, we support the proposed decision and wish the authorities success in their future endeavors.

Mr. Hamilius remarked that, as the major issues had already been discussed, he would focus briefly on only one point. As the charts showed, Namibia's 1993 exports were dominated by only two sectors: the mineral sector, making up about 55 percent of exports; and fisheries, making up about 25 percent of total exports. The dangers of dependence on only two industrial sectors were immediately apparent. A major effort at export diversification was called for, especially in view of the staff's prediction that the surge in fish exports would turn out to be only temporary, while the outlook for mineral exports was dimmed. It might be interesting for the Namibian authorities to consider making the country a general competitive production area to the whole region, as the former Eastern European countries did for Western Europe, although that might require re-examining the present wage policy, which closely linked Namibian and South African wages. The implementation of such a system could also have reduced unemployment, especially of unskilled labor. Namibia's current industrial system was a source of concern, as the unemployment situation would probably continue to worsen in 1994--even though the outlook for economic expansion had improved--as no sector appeared likely to provide significant employment gains.

As the staff had noted, "given the small size of the Namibian economy, growth will have to be primarily export led," Mr. Hamilius continued. He urged the Namibian Government to take all that into account when they introduced their first medium-term development plan in 1995.

Mr. Dorrington noted that Namibia had a balance of payments surplus and reserves were growing, but were low. He wondered whether in the circumstances there might be a role for a classical stand-by arrangement. Such an arrangement, which would strengthen confidence, would require some policy changes, which, of course, would be beneficial in their own right. And there was quite a lot that was right with the authorities' policy intentions at present, in any event. He would welcome a response to his question from the staff or Mr. Dlamini, including to the question of whether there was a balance of payments need. The policy changes that would be necessary presumably would be broadly along the lines discussed in the staff appraisal, and he would be interested in anything that was currently known about the attitude of the authorities to a stand-by arrangement.

Mr. Golriz made the following statement:

Following two years of buoyant output, economic activity in Namibia slowed down and GDP decreased by more than 3 percent in 1993. This has been attributed by staff to "weak performance of the mining sector." However, recent political developments in South Africa, Namibia's major trade partner, might have played a role as well. We note from staff report that Namibia's volume of imports and exports declined in 1993 by 2.3 percent and 4.7 percent, respectively. With the re-entry of South Africa into the world market, we wonder whether Namibia will be able to maintain its preferential access to South Africa's market. For this, and other reasons detailed in the staff report, Namibia will need to reorient its policies and reinforce efforts to enhance its competitiveness and diversify its economy.

The most immediate challenge facing the authorities is the supply side of the economy, as growth is stagnant and the unemployment rate is as high as 30 percent. Indeed, a discouraging feature of Namibia's economic performance is that investment has decreased sharply, and in 1993 was only 9.6 percent of GDP, compared with its 1990 level of 19.6 percent. More disturbing is the private sector's share in investment, which declined by half during the same period.

While we urge the authorities to take immediate steps to reverse this trend, we would appreciate the staff's comments on the reasons for such a downfall of investment, as well as its view on a sustained investment strategy.

Namibia has a relatively well-developed infrastructure that provides potential for diversified growth. Current policies, however, need to be reoriented toward better mobilization of domestic resources. More investment aimed at expansion of different activities, including fisheries, mining, tourism, and possibly agriculture are needed to create jobs and secure sustained growth. We would appreciate staff views on other feasible labor-intensive activities that could help alleviate the unemployment problem. We would also appreciate the staff's comments on the reasons for capital outflows by the pension funds and insurance companies, despite the fact that interest rates have been adjusted in Namibia.

As to monetary policy, we learn from the staff report that Namibia has limited scope for a monetary policy independent from that of South Africa. However, with the introduction of the new national currency, Namibia has taken another crucial step, following the establishment of the Bank of Namibia, toward a more independent monetary policy. The system has been working under a currency board arrangement. We would appreciate staff comments on the extent of the leverage that the currency board can exert, in view of Namibia's integration with the Common Monetary Area (CMA). We note that the authorities do not intend to delink from the South African rand as long as the situation in South Africa remains stable. But we fully share the staff's recommendation that a contingency plan should be developed for exchange rate policy actions to be taken if major policy changes occur in South Africa. If the introduction of new currency signals an eventual delinkage from the rand, this calls for the necessary preparations.

As the authorities have rightly recognized, in the circumstances, a crucial task is building confidence in the new currency, and that requires a credible fiscal stance in Namibia.

More important, as the staff emphasizes, reducing the present deficit is imperative for the sound operation of the monetary and exchange rate system. We share the authorities' view that the scope for further improvement in revenue generation is limited, owing to the already-high tax rate and the narrow production base. Although perhaps there are prospects for a greater contribution from the wealthy users of social services. We are also inclined to support switching to a value-added tax system based on efficiency arguments, even if this shift proves to be revenue neutral in the short term.

Much more can be done on the expenditure side. First, the wage bill should be under close control, as it remains the real source of concern. Table 20 of the statistical appendix shows that during 1990-93, wages in the formal sector have increased by more than three times, much beyond the price increases. We therefore welcome the authorities recent wage policy, under which there was no increase in 1993. We also consider that it would be appropriate to link future wage increases to improved productivity. Second, social spending must be better targeted to protect the neediest segments of the population. Finally, the budget burden should be reduced through privatization and commercialization of the state-owned firms. It is noted that a sizable portion of the economy, which can perhaps be run more efficiently by the private sector, remains under government control. We understand that privatization is limited, owing to some constitutional constraints that emphasize the "mixed economy" concept for Namibia. However, as the Government remains the largest employer in the country and the wage bill remains a heavy burden, we wonder whether there is an ongoing or future plan to downsize the Government.

Namibia's rich land, geographic location, relatively developed infrastructure, and low external debt give the country a great potential for sustainable growth. Furthermore, recent political events in the region have created a unique environment for cooperation that, in a longer perspective, will stimulate a viable growth for all countries of the region. The authorities should spare no time in capitalizing on such an exceptional opportunity.

With these remarks, we support the proposed decision and wish the authorities well in their endeavors.

The staff representative from the African Department observed that the magnitude of capital outflows to South Africa varied from year to year. As noted in table 32 on page 33 of the statistical appendix, the total of life insurance and pension funds was approximately $270 million in 1993. As to whether the staff had encouraged pension funds and insurance companies to invest in Namibia, it should be noted that there was no lack of willingness by pension funds and insurance companies to invest in Namibia, only a lack of investment opportunities. The Pension Fund Act encouraged those institutions to invest part of their financial assets in Namibia. The staff's position was that, as long as the investment was voluntary, it would not be against it; but the staff was not in favor of administrative arrangements that would require institutions to invest in Namibia up to some specified amount.

Mr. von Kleist recalled that the staff report spoke of "the present level of budget deficit and the domestic savings constraint on investment hampering investment and growth." That sentence seemed to contradict the view that there were no investment opportunities in Namibia.

The staff representative from the African Department replied that the insurance companies and pension funds actually were investing in Namibia, but not of a magnitude equivalent to $270 million, at least not in the short term. Injection of that amount into the Namibian economy had to be done over time, gradually and slowly, as opportunities for investment arose.

Mr. von Kleist asked whether that meant there was no domestic savings constraint. Obviously, the money was available, but could not be invested, so there could not be a domestic savings constraint if the money had to be exported to be invested. That was the heart of his question. Was there a domestic savings constraint or not?

The staff representative from the African Department replied that the staff was not attempting to give the impression that there was a savings constraint in the country. It was simply that the level of savings currently being conducted was not adequate to provide for a sustainable rate of growth, and, therefore, the lack of opportunity for investment was not necessarily a detriment to, or a constraint on, investment. The argument of those institutions was that they could not always find a place to invest and, therefore, they had to rely on the South African market, actually, as a place for their investment. As to whether they should do that or not, the mission always took the position that no administrative regulation should be imposed on them, but the Government definitely has been encouraged to put in place an incentive structure that would encourage them to identify investment opportunity in the Namibian economy and put money back into the economy.

With regard to the Pension Fund Amendment Act, the mission had not expressed any particular views, the staff representative continued. Because of the timing of the mission, the act was still not finalized. It was in the draft stages. So the staff still had no major input into the Act because the staff had not been informed about its details until after it had been finalized and made public.

On the lack of fiscal discipline and its impact on the credibility of the new currency, the staff representative commented that, in various places in its report, the staff had tried to show that lack of fiscal discipline definitely would have an adverse impact on the credibility and stability of the new currency, and unless Namibia pursued a very prudent and restrained fiscal policy with the aim of trying to boost economic growth and increase the buildup of reserves, the new currency's credibility would be jeopardized substantially, in both the short and medium terms.

On the potential of economic impact of Walvis Bay, at the time of the mission, the authorities had been struggling with the issue of information, the staff representative continued. Data available to them apparently had been a major issue in discussions with the South Africans. The argument had been that Namibia was never being given any detailed information as to what the economic and financial situation for Walvis Bay was, and, therefore, they could not give the mission any numbers as to what the net effect of the transfer of Walvis Bay to the Namibian authorities would be. Indicative figures provided to the mission suggested that, in the very first year, Walvis Bay would result in a net revenue transfer to the treasury of something in the magnitude of R 4 million. Other than that, a commission had been set up, and after the transfer of Walvis Bay into the Namibian hands, the commission was supposed to study within six months the exact economic and financial impact of Walvis Bay on the Namibian economy, and provide a cabinet memorandum that was supposed to be available late in the third quarter of the year.

Progress on implementation of policy measures intended by the authorities had been limited as, so far, no major measures had been taken, the staff representative said. The budget had been approved only about a month earlier, and the delay in the World Bank public expenditure review mission would definitely slow the process of implementation, simply because the

Government was putting a lot of weight on the outcome of the public expenditure review and subsequent recommendation. Also, the medium-term development plan had not been finalized as expected, and there, too, a number of policy measures were supposed to be incorporated in the plan, which, together with the public expenditure review, was supposed to be developed in the cabinet memorandum setting out an action program on which the Government intended to embark immediately after the cabinet approved the action plan.

Finally, the staff representative noted, on the scope for a stand-by arrangement, the mission had found the authorities not showing much interest in such a facility, perhaps because of the Government's current policy of not engaging in any commercial overseas borrowing. The authorities were also not borrowing from the World Bank, for the same reasons. Beyond that, however, the staff's medium-term outlook clearly indicated that, even on conservative projections, Namibia's reserves would build up gradually over the next few years; and that also weakened the argument for a stand-by arrangement. Similarly, Namibia was not experiencing a surge in imports; nor was there evidence of a strong variation in export earnings. Theoretically, of course, a stand-by arrangement remained a possibility, but the Namibian authorities claimed to be as conservative as the Fund, and, as the medium-term scenario showed that they would be in a position to build up their reserves, they felt that they could pursue a very prudent fiscal policy without resorting to a stand-by arrangement.

Mr. Dorrington reiterated that he had been speaking of a "classical" stand-by arrangement, one that was not necessarily drawn upon. The stand-by arrangement should be used as a safety net during the vulnerable period, while the reserves were being built up.

The staff representative from the African Department repeated that, while the staff had not pursued the matter with vigor, the authorities had simply not shown any interest in a stand-by arrangement.

The staff representative from the Policy Development and Review Department remarked that Mr. Dorrington's question implicitly assumed--correctly--that balance of payments need in its classical and in its legal sense was not a requirement for approval of an arrangement. It was, however, a requirement for purchases under a stand-by or an extended arrangement.

Mr. von Kleist recalled from the staff paper the indication that some R 400 million was circulating in the Namibian economy. Strictly speaking, those were reserves for the Namibian economy, and they were 2 1/2 times as large as official reserves. Hence, a possible balance of payments need of the sort hinted at by Mr. Dorrington would be alleviated by the huge level of reserves circulating in the country.

Mr. Dlamini noted that the importance of pursuing a sound fiscal policy had been emphasized by many Directors. As an independent nation, Namibia was only four years old. Because of the inherited gross social and economic disparities, the expectations of the population for increased spending on social programs were very high and continued to put considerable pressure on the government budget. Problems were also posed by the current wages policy, which linked salaries in Namibia with those in South Africa, and which had been inherited by the authorities from the former rulers of the territory. The policy created enormous pressures on the budget.

The authorities were well aware of the dangers likely to arise from financing a high and unsustainable deficit, Mr. Dlamini continued. They, therefore, intended to reduce the fiscal deficit in financial year 1994 with appropriate fiscal measures, and to continue to exercise vigilance and perhaps to make further efforts on the fiscal front in the following years until the deficit is reduced to a sustainable level. The authorities also recognized that a policy of social betterment could not be successfully and sustainably pursued without economic growth. They therefore intended to place more emphasis on the creation of an environment in which the private sector could act as the main engine of economic growth and job creation. Already, some encouraging efforts had been made on that front, including through the granting of tax incentives. At present, the authorities' ability to manage economic growth and address social problems was limited. There was therefore an urgent need to invest in capacity building, especially at the level of education and training. The continued role of the Fund in providing technical assistance in those areas would be crucial.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal. Directors noted that Namibia had made encouraging progress on many fronts since achieving independence four years ago, despite difficult challenges inherited from the past. However, Directors indicated that, caused by the understandable need to boost social spending and government employment, growing fiscal pressures had developed, which together with the inflationary environment, had led in recent years to low levels of savings. These savings had become increasingly inadequate to deal with the country's efforts to spur employment and bring about a resumption of economic growth, following a disappointing outcome in 1993.
>
> Against this background, Directors stated that it was important to restore the conditions for sustainable growth within a restrained macroeconomic framework centered on decisive and lasting fiscal consolidation. While welcoming recent efforts to control the budget deficit, Directors called for intensified current expenditure restraint, notably through the containment of public sector employment and firm resistance to excessive wage increases, and the curtailment of spending outside the budget. In this context, Directors also noted the ongoing public expenditure review with the assistance of the World Bank, and they encouraged

the authorities to implement its recommendations as soon as they become available.

Directors supported the measures contained in the 1994/95 budget to reduce government expenditure, as well as the authorities' medium-term strategy, to gradually reduce the budget deficit to a more sustainable level by 1996/97. To strengthen budgetary control in the medium term, it will be necessary: to eliminate overstaffing; to make more effective use of donor support and private participation in development projects; to continue to address fiscal issues and establish an effective budgetary process, with particular attention to the need to integrate recurrent and development budgets; and to coordinate borrowing requirements and fiscal policy in order to assess appropriately the budgetary impact of future debt service. Fiscal consolidation and prioritization are all the more important in light of the pressing need to improve education, health, and housing for the poor sections of the population, the need to raise the level of domestic savings, and the need to promote investment efficiency. In view of the uncertain revenue outlook relating mainly to the future of SACU receipts, which amount to about 10 percent of GDP, Directors underscored the importance of preparing a fiscal restructuring in case of need.

Directors noted with concern Namibia's high level of unemployment and stressed the need for a comprehensive set of policies aimed at increasing labor absorption by fostering an economic environment conducive to expansion of private sector activity, including a higher level of private investment, and a lower level of labor costs. In addition to training, this would require a more coherent employment strategy.

Directors commended the authorities for the smooth and successful introduction of Namibia's new currency, the Namibian dollar. They emphasized, however, that the credibility of the new currency would essentially depend upon the implementation of sound and prudent financial and economic policies in the period ahead. Moreover, Directors stressed that the maintenance of prudent financial policies--especially, budgetary discipline--would play a major role in safeguarding the international strength of the Namibian dollar and maintaining the confidence of private investors.

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

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 1994 Article XIV consultation with Namibia, in the light of the 1994

Article IV consultation with Namibia conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/94/113, Namibia maintains restrictions on the making of payments and transfers for current international transactions under the transitional arrangements of Article XIV, Section 2, in the form of (i) limits on certain transfers to nonresidents, (ii) limits on travel and emigrants' allowances, and (iii) a multiple currency practice arising from the dual exchange rate for the commercial and financial rand. The Fund urges Namibia to eliminate these restrictions as soon as possible.

Decision No. 10708-(94/52), adopted June 8, 1994

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/51 (6/6/94) and EBM/94/52 (6/8/94).

8. ESAF TRUST - CENTRAL BANK OF EGYPT - LOAN ACCOUNT - BORROWING AGREEMENT

Pursuant to Section III, Paragraph 2 of the Instrument to Establish the Enhanced Structural Adjustment Facility Trust, the International Monetary Fund, in its capacity as Trustee of that Trust, approves the agreement for borrowing from the Central Bank of Egypt in terms of the draft agreement set out in the attachment to EBS/94/115, and authorizes the Managing Director to take such action as is necessary to conclude and implement the agreement.

Decision No. 10709-(94/52) ESAF, adopted June 7, 1994

9. <u>EXECUTIVE BOARD TRAVEL</u>

Travel by Executive Directors as set forth in EBAM/94/93 (6/6/94) is approved.

APPROVAL: February 15, 1996

LEO VAN HOUTVEN
Secretary