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April 24, 1997
Approval: 5/1/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/80

10:30 a.m., August 28, 1996

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance
S. Fischer, Acting Chairman
P.R. Narvekar, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
	P. Cailleteau, Temporary
	L. Fontaine, Temporary
	H. Paris, Temporary
	J. Guzmán-Calafell, Temporary
	C.X. O'Loghlin
	P.A. Akatu, Temporary
	J. Mafararikwa, Temporary
B. Esdar	A. Guennewich, Temporary
	J. Shields
	C. Austin, Temporary
	K. Brownlee, Temporary
	J.N. Santos, Temporary
	L.M. Cheong
	K. Sundara, Temporary
	D. Gotz-Kozierkiewicz
	G.P. Ramdas, Temporary
W. Kiekens	J. Hamilius, Temporary
	V. Rigász, Temporary
Y.-M.T. Koissy	
	M.A. Brettschneider, Temporary
	D.G. Loevinger, Temporary
	M.W. Ryan, Temporary
	H. Ono
	Y. Tahara, Temporary
	M. Daïri
	J. Leiva, Temporary
A.S. Shaalan	
M.R. Sivaraman	H.B. Disanayaka
	B. Andersen
	A.V. Mozhin
	M. Cilento, Temporary
	Y.G. Yakusha
	He J., Temporary
	Song J., Temporary
	Zheng H., Temporary

R.H. Munzberg, Associate Secretary
W.S. Tseng, Acting Secretary
P. Cirillo, Assistant

Also Present

IBRD: T.O. Ahlers, Africa Regional Office; J.J. Dethier and M. Noel, Europe and Central Asia Regional Office; L. De Wulf, Middle East and North Africa Regional Office. S. Shah, South Asia Regional Office. African Department: P.A. Acquah, E. Sacerdoti. European I Department: M. Russo, Director; M.C. Deppler, Deputy Director; C. Cottarelli, N.T. Feyzioglu, T. Krueger, L.J. Lipschitz, R. Moghadam, R.N. van Elkan. Fiscal Affairs Department: K. Kostial, E. Ruggiero. Legal Department: P. De Boeck, L.E. Nordgaard, J.M. Ogoola, D.E. Siegel. Middle Eastern Department: M.A. El-Erian, Deputy Director; P. Alonso-Gamo, P.J. Duran, A. Jbili. Policy Development and Review Department: T. Leddy, Deputy Director; J. Ferran, Deputy Director; K.H. Kang, S.M. Nsouli, P.J. Perone. Secretary's Department: K.S. Friedman. Southeast Asia and Pacific Department: A. Singh, Deputy Director; C.M. Browne, M. Cangiano, M.R. Kelly. Statistics Department: M.A. Wasfy. Treasurer's Department: C.A. Hatch. Office of the Managing Director: S. Sugisaki, Special Advisor. Advisors to Executive Directors: M.B. Alemán, K.M. Heinonen, J. John, J. Justiniano, M.-H. Mahdavian, Y. Margoninsky, M.F. Melhem, G. Mucibabici, S. N'guiamba, S. O'Connor, M. Petrie, R. Rainford, Assistants to Executive Directors: P.I. Botoucharov, M.A. Brooke, D.S. Hakura, R.J. Heinbuecher, O. Issaev, H. Javaheri, H. Kaufmann, E. Kouprianova, K. Kpetigo, T.-M. Kudiwu, G.A. Kyriacou, N.L. Laframboise, J.P. Leijdekker, B.M. Lvin, I. Moon, Ng C.S., S. Simonsen, V. Trivedi, V.Y. Verjbitski, A.-G. Yakub.

1. HUNGARY—1996 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT—REVIEW, WAIVER, AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered the staff report for the 1996 Article IV consultation with Hungary and the first review under the 23-month Stand-By Arrangement for Hungary approved on March 15, 1996, as well as Hungary's request for a waiver and modification of performance criteria (EBS/96/123, 8/6/96; and Sup. 1, 8/26/96). They also had before them a background paper on selected issues in Hungary and statistical tables (SM/96/207, 8/7/96; and Sup. 1, 8/7/96).

Mr. Kiekens made the following statement:

Hungary's stabilization and reform program, which has been supported since March 1996 by a precautionary Stand-By Arrangement, remains on track. Basically all targets were met. It has produced remarkable results.

Exports surged in 1995 to 168 percent of the previous year, reducing the current account deficit from 9.5 percent of GDP in 1994 to 5.6 percent in 1995. Hungary's net external debt dropped from 45.8 percent of GDP in 1994 to 37.6 percent in 1995. The government is confident that the current account deficit target of 4.3 percent for this year will be realized.

Equally noteworthy is the sizable reduction of the public sector. The primary expenditures of the consolidated government dropped from almost 50 percent of GDP in 1994 to 41.4 percent in 1995, improving the balance of the primary budget by 3 percent of GDP, excluding privatization receipts, which amounted to 2.8 percent of GDP.

Consequently, international confidence in the Hungarian economy has improved significantly. The interest rate premium charged on Hungary's sovereign debt has decreased sharply and Hungarian banks and enterprises now have improved conditions for borrowing on the international capital markets. At the start of the stabilization process, Hungary's bonds were trading with a premium of almost 300 basis points. On the occasion of the latest issue in July this year, the spread had dropped to only 50 basis points over LIBOR. The July bond issue was cited by a member of the international banking community as setting a new standard for the emerging economies of Central and Eastern Europe.

Admittedly, output growth of 1.5 percent in both 1995 and 1996 is modest in comparison with the fastest growing transition economies, but is nevertheless considered satisfactory in light of the severe demand constraints imposed by the stabilization program. With private consumption shrinking by 5.7 percent last year and by 3 percent this year, Hungary 's growth is entirely on account of a strong real export growth (by 15.4 percent in 1995 and expected to be about 13 percent in 1996) and investment growth expected to be around 12 percent in 1996. If external demand picks up, growth will recover fully once the effects of the austerity program have been absorbed.

Notwithstanding the severe demand constraint, average inflation for 1996 is likely to remain at 23–24 percent, compared to the original target of 20 percent. This excess is explained by the unexpectedly large carryover and demonstration effects of the administrative price increases in late 1995, which accounts for more than half of the excess, and, possibly, by the lagged effects of the spring 1995 devaluation. Given the risks of inflation inertia for the program targets, particularly those for the external accounts and public finances, the authorities' policy response was rightly one of the major topics of the review and consultation discussions.

The Hungarian authorities remain committed to cut annual inflation further to about 14–16 percent by the end of this year, and bring the underlying inflation rate down to slightly over 10 percent during the last quarter of 1997. They will lower this target further if the coming months see inflation decelerating faster than currently expected. Those targets are considered compatible with the achievement of the program targets, although they reduce the room for further slippages.

In order to at least partly offset excess inflation, the government accelerated the gradual phasing out of the import surcharge, starting with a reduction of 1 percentage point on July 1 and another on October 1 of 1996. The remainder of the 8 percent import surcharge will be completely eliminated by June 1997. This measure will improve economic efficiency and growth.

The authorities decided not to change the basic stance of their monetary and exchange rate policies as intended at the start of the program. Hence, the exchange rate, which serves as a nominal anchor for the economy, will continue to be depreciated in nominal terms at the rate of 1.2 percent monthly for the remainder of 1996. This rate may be decreased in 1997, if the balance of payments and inflation behave as programmed.

As in several other emerging market economies, monetary policy in Hungary is complicated by relatively large capital inflows, including those stemming from reverse currency substitution. Changes in the demand for money, which quite naturally occur in response to the fundamental changes in the macroeconomic environment, are an additional complicating factor.

The central bank remains determined to slow the pace of the interest rate decline caused by the continued inflows of foreign capital. Official interest rates will only be reduced if there is a clear deceleration of inflation. Capital inflows will be sterilized as needed, and the net domestic assets of the central bank will be strictly contained. With interest rate differentials vis-à-vis other currencies in decline, it is expected that future capital inflows will be manageable.

In addition to an exchange rate depreciation, fiscal restraint, and structural reforms, Hungary's March 1995 program relied heavily on a rigorous incomes policy to improve its external competitiveness and increase the savings rate. In 1995, real wages declined by 13 percent. In 1996, nominal wage increase in the public sector will be kept 1 percent below the targeted inflation rate. The excess inflation of about 4 percent will therefore cause real wages in the public sector to fall by 5 percent in 1996. Taking account of the increase in income taxation, real disposable income will decrease by as much as 8 percent. The government is determined not to accept, this year, additional salary increases to offset the excess inflation.

With employment declining in the public sector, including state-owned enterprises, the effect of public sector wage constraints on the overall labor costs of the economy is declining as well. However, the discipline imposed by the exchange rate regime is helpful in containing labor costs in the export sector, although one cannot deny that over time, as in other economies, wage developments in the services sector may spill over into the traded goods sector.

With the room for maneuver of monetary policy limited, and incomes policy losing some of its effectiveness, fiscal restraint has become the main instrument of macroeconomic management.

In 1996, the fiscal deficit will be further reduced as consistent with the targets for the current account. Also the level of public revenues and expenditures will be further decreased, together with the government's redistributive role.

The slippage in the social security budgets in the first half of 1996 was more than offset by a better than expected outcome for the government's budget. Higher corporate income taxes, value-added tax revenues, and import duties in particular will help bring the consolidated fiscal deficit down from around 7 percent of GDP last year to the targeted 4 percent this year. Admittedly, the end June 1996 performance criterion for the consolidated government budget deficit was met only with a small margin. Consequently, continued pressure form the social security deficits and from the unexpectedly high interest costs resulting from the excess inflation will severely constrain fiscal policy for the remainder of the year. But notwithstanding these emerging difficulties, our authorities are determined to meet the end 1996 program targets.

The 1997 fiscal consolidation target will be maintained at 3 percent of GDP. This figure excludes privatization revenues and adjustments both for the financial flows related to the securitization of the accumulated exchange rate losses of the central bank, and for part of the costs of its sterilization operations. Budget guidelines aimed at a primary surplus of 4.5 percent of GDP have already been approved by the Council of Ministers.

Of course, prudent macroeconomic policies, however useful during the transition, must be accompanied by extensive structural reforms in order to bring lasting benefits. The program therefore contains structural benchmarks for monitoring progress in the four areas where structural reform is most urgent.

One of the principal areas requiring reform is the social security system. Parliament took a major step in July with passage of new rules readjusting the retirement age and increasing the minimum service needed to quality for benefits. The government also finalized its plans for pension reform, which with the aid of the World Bank, should be ready for parliamentary approval by the end of February 1997.

The planned reforms in the health care system will free up resources for maintaining a sound social safety net for the needy, but the present poor financial conditions are causing program delays. For example, the elimination of 10,000 hospital beds mandated under the program requires heavy initial outlays, for which funds have not yet been found, before savings can be realized later on.

After a surge of sales at the end of 1995, which brought in some two-thirds of the total cash revenues to be expected from the entire 1995–97 privatization program, the pace of privatization is bound to slow down.

The Treasury system introduced at the beginning of 1996 will increase the transparency and control of the government finances and greatly facilitate the ongoing consolidation of public finances. These changes, combined with the planned further downsizing of public sector employment, will provide a solid basis for a strong macroeconomic performance over the medium term.

Mr. Shaalan made the following statement:

Important progress has been achieved since Hungary began its present adjustment program in March 1995. While the government budget deficit was reduced only modestly in 1995, the strong fiscal consolidation measures undertaken laid the groundwork for an expected substantial further reduction of the budget deficit in 1996. Sharp expenditure reductions on subsidies and social transfers already begun in 1995, as well as a compression of real wages in the public sector and a retrenchment of public employment, are expected to bring about a reduction in the fiscal deficit from 7.5 percent of GDP in 1994 to 4 percent in 1996. In the external sector, restrained demand policies and the significant devaluation of the forint resulted in a marked reduction in the current account deficit which had widened significantly over the previous two years. Increased foreign direct investment and other capital inflows also boosted gross official reserves and allowed a significant reduction in Hungary's external debt. Further improvements in the external sector are expected for 1996 as suggested by developments in the first half of this year. In addition, a modest rise in output was sustained for both 1995 and 1996.

Disappointing developments on the inflation front, however, have clouded the authorities achievements during the past eighteen months and could undermine the progress achieved thus far. The persistent inflation inertia of the past few years during which Hungary implemented reform programs that were supported by two Fund arrangements, an Extended Arrangement followed by an Stand-By Arrangement, are a cause for concern. The staff's analysis of Hungary's inflation performance over the past few years in the useful background paper points to the usual culprits, the most important being the failure of demand side policies to target a rapid reduction in inflation. Annual inflation targets in previous Fund-supported stabilization programs were not sufficiently ambitious. Hence, it is not surprising that progress on the inflation front was also modest, even though inflation outcomes were close to program targets. In contrast, the authorities' inflation target for 1995 was more ambitious. However, financial and incomes policies needed to be tighter to support the substantial exchange rate devaluation and the implementation of a crawling peg policy. Consequently, 1995 inflation developments fell short of expectations.

For 1996, the staff report indicates that the inflation targets envisaged in the Stand-By Arrangement for 1996 and 1997, namely 20 percent and 13 percent respectively, are not expected to be attained unless financial policies are tightened further. Under these circumstances, and in view of the persistent failure to bring inflation under control despite five years of stabilization efforts, it is disappointing that the authorities have chosen to adjust their inflation objectives upwards both for 1996 and 1997, rather than implement a significant policy tightening. I agree with the staff that, at a minimum, it will be essential that the fiscal target for 1996 is strictly adhered to. This will be of the utmost importance since, as Messrs. Kiekens and Cserés note in their most helpful statement, the room for maneuver of monetary policy is limited and incomes policy appears to be losing some of its effectiveness. In this connection, I am encouraged by the authorities' commitment to take corrective action should the 1996 fiscal targets be in danger and by their intention to firmly resist pressures for wage increases in the public sector that are likely to intensify in the coming months. I am also pleased that the latest data presented in the staff supplement indicate an improved outlook for the central budget position. The deterioration of the position of the social security accounts, however, continues to pose a risk to the achievement of the fiscal target. Close monitoring of developments will be crucial.

For 1997, the authorities are urged to maintain the program's original inflation target and to adopt tighter financial policies than originally envisaged to assure its attainment. The authorities' announcement of upward revisions of planned cuts in primary expenditures and revenues in the 1997 budget are welcome developments that would reduce what are clearly high public revenue and expenditure ratios as compared to many other European countries. Nevertheless, a clearer identification of the expenditure cuts planned for 1997 is needed. In addition, I would agree with the staff that reductions on the revenue side should be contingent on a strict implementation of the planned cuts in expenditure.

Monetary policy and structural reforms should, of course, be geared to support the program's stabilization and adjustment objectives. Interest rate policy at this stage should be directed primarily at achieving the elusive inflation objective. The narrowing of interest rate differentials lately should allow the authorities to keep interest rates high without inducing an excessive inflow of short term capital inflows that would complicate the management of monetary and exchange rate policy. Full implementation of the structural reform agenda will also be crucial to achieving the projected fiscal consolidation and hence in reducing inflation. In this connection, the delay in the health and pension reforms are particularly regrettable since they form an integral part of the fiscal consolidation process. The authorities' commitment to obtain parliamentary approval of the comprehensive pension and disability reform prior to the completion of the second review is, therefore, welcome.

To conclude, I support the proposed decision and wish the Hungarian authorities renewed vigilance in the pursuit of their reform objectives.

Mrs. Cheong made the following statement:

Hungary has made much progress in its transition to a market economy, with credit being due to the authorities' implementation of a sound economic adjustment program. Most notable is the marked improvement in the external sector with lower debt, better response of capital markets to new bond issues and a comfortable level of foreign reserves. In addition, most performance criteria and structural benchmarks under the Stand-By Arrangement arrangement were met. The only cloud in the horizon is the seemingly less dedication to policies that would create a low inflation environment, a stance that could be harmful to the adjustment success achieved to date, and could also impair further adjustment efforts.

I found the staff analysis of the inflation issues very illuminating. As the staff has clearly drawn out the underlying factors attributing to the inflation inertia in Hungary and as this institution has always been consistent in its advocate of high inflation being the source of all economic ills, I am rather confused that the staff seems to be quite at ease with the relaxation of inflation reducing targets by the authorities. As I understand it, the staff believes the risks to be manageable as the external position will remain strong. On the other hand, in the medium-term scenario, the staff mentioned that risk of external demand factors could exacerbate adjustment difficulties. On the authorities side, I can understand them wanting to be practical and realistic by aiming for less ambitious targets to gain political consensus. But I wonder whether this approach in light of little progress recently, could make inflation entrenched at high levels, as the public could come to view that inflation targets need not be adhered to. As it is, wage pressures already seem to reflect inflation expectations.

Given the causes of inflation being largely related to cost-push and administered prices, it would be possible to address inflation through a two-pronged approach—demand management and improving the supply response. Liberalization of price controls have one-off impact on inflation, while the effect of tax increases on some items are offset by other items being included in the lower tax category. Evidence that businesses reduce production when demand eased, together with increasing enterprise profitability, indicate possibilities of high concentration ratios in the supply of goods which are conducive to limiting competition. Improving supply conditions through measures to ease business transactions, could go a long way to help reduce the inflation inertia. Without an adequate progress in structural reforms to ease supply response, I doubt that even further tightening of fiscal and monetary conditions would break this inflation inertia given the business environment. In addition, some policies or moral suasion to encourage more restraint in real wage adjustment should also be considered, at least until there are signs that downward price rigidities and inflation expectations are easing.

The commitment to fiscal consolidation remain strong. The impact of downsizing the government would help mitigate demand pressures. The authorities' pursuit of a two-pronged approach to fiscal adjustment on the revenue and the expenditure sides of the budget, has shown encouraging net results last year and the expected faster reduction in expenditure over revenue this year will provide a further dampening effect on inflationary pressures. The authorities' commitment to use all receipts from privatization to lower government debt instead of increasing expenditure is in the right direction. But, whether this adjustment would be sufficient in ensuring the achievement of the inflation target is yet to be seen. While I concur with the staff's recommendation that fiscal policy be tightened further so that the deficit for 1996 could be lower than the program's ceiling of 4 percent of GDP, the impact on inflation will depend on other structural factors to improve supply constraints.

In this regard, I can understand the authorities' concern that a stronger fiscal tightening could represent an overkill of domestic demand that could lead the economy into recession, although the current strong performance in the external sector would offset any lower public sector contribution to output growth. The evidence last year showed that the strong fiscal adjustment was not accompanied by a major output loss. However, it is also important to ensure that structural changes continue to improve efficiency and productivity so that this can offset the contractionary impact of the fiscal adjustment on output growth.

On the monetary front, it is well recognized that the conduct of monetary policy was constrained by the emergence of short-term capital inflows during last year and early this year, driven by the high interest differentials while the exchange rate was not allowed to adjust flexibly. As a result, the interest rate was forced to decline to equilibrate the imbalance in the foreign exchange market and the growth of monetary aggregates accelerated. Although this phenomena seems to have subdued during the last three months in response to the lower interest rate differential, the risks for a revival of capital inflows in the period ahead still remain. In this regard, I would appreciate the staff's explanation of role of exchange rate. I understand that the exchange rate is also intended to influence competitiveness of exports and I am curious how the authorities can be confident of being able to completely stabilize new inflows as stated in Mr. Kiekens's statement. In particular, elaboration of sterilization instruments would be helpful in light of the lower government deficit that could reduce the need to issue new papers.

Let me conclude by saying that I am less confident then the staff on external factors, which could change quickly. A proper balance of policy mix is required. More important, is the demonstration of willingness on the part of the authorities to address inflation on all fronts by seeking political consensus for more ambitious targets. Structural measures to break the inflation inertia and measures to change business practices, could lead to better results than just stronger fiscal or monetary policies.

With these remarks, I support the proposed decision.

Mr. Ryan made the following statement:

We continue to find much encouragement in Hungarian policy performance. Last year witnessed a dramatic reversal in what had been unsustainable trends in fiscal and external account imbalances and was capped by the huge volume of state enterprise sell-offs in the last quarter. While recent performance has been subject to some slippages, the overall direction of policy remains favorable. We are happy to support the proposed decision. The staff report and background papers highlight a few key issues that I would like to explore in some greater detail.

The factors underlying the apparent stickiness in inflation despite still high unemployment and a weakening in output over the later half of 1995 and first half of 1996 are subject to some uncertainty. The staff paper notes that larger-than-expected administered prices account for half of the 4 percentage point overrun in inflation—so the actual overshooting of most concern to policy makers may be somewhat contained. A number of factors may be at play, as is noted in the staff paper, and I wonder if the staff could comment in a bit more detail on how it sees this story evolving—particularly on the supply-side. It has been observed generally, for example, that relative price adjustments in the service sectors of transition economies can be rather protracted. In addition, to the extent that a lack of competition in the service sector has permitted the pass-through of excess wage settlements, one wonders if recent privatization activity will have a positive countervailing effect. One also wonders about rigidities in the economy that are inhibiting the flow of labor from depressed to more active regions (or vice versa regarding capital).

The persistence of inflation and the complications for monetary policy posed by capital inflows earlier this year will inevitably invite questions regarding the appropriateness of the crawling peg. The argument has been made by some in previous Board discussions that monetary policy should be more firmly focused on price stability and that this is best facilitated by freeing up the exchange rate so as to permit nominal appreciation of the forint as a means for dealing with capital inflows. As regards the impact on competitiveness, the argument goes, better to have a real appreciation occur through nominal movements in the exchange rate rather than through inflation.

While the persistence of inflation is a concern, there would appear to be risks to moving prematurely to a new anchor. First, there are the ongoing uncertainties regarding the demand for money that would make it difficult to establish a credible monetary anchor. There are also risks, it would seem, to jettisoning one anchor for another after just over one year. Given that the crawling peg was preceded by a policy of rather ad hoc devaluations, markets might question the credibility of a new anchor—particularly given the uncertainties mentioned previously.

We can understand the apprehensiveness of authorities—at this stage—to any significant nominal appreciation in the currency. Hungary's external debt profile has improved, but the burden remains substantial. And while the current account deficit has declined, it is still at levels, 5.6 percent in 1995, 4.3 percent expected in 1996, that counsel caution. Over time, of course, as the impact of privatizations and other structural reforms take hold, the expected improvements in corporate governance and productivity may allow for a more flexible approach to the competitiveness issue.

In our view, therefore, the appropriate policy stance at this stage is to look to continued planned fiscal tightening to ease the burden on monetary policy and help reduce the pace of capital inflows—which have declined in recent months as the interest differential has narrowed. The staff may want to comment on how it sees the current monetary policy regime evolving over time, including under what conditions a move to a more flexible exchange rate and monetary anchor might be appropriate.

Regarding the role and impact of fiscal policy in attaining a viable external position, it is interesting to note that despite a substantial projected reduction in the deficit (nearly 3 percentage points of GDP) this year, the impact on the current account is relatively modest (about 1.3 percent reduction in GDP). This could be explained by lower private savings and/or increased private investment. The former would be unfortunate; the latter—an increase in private investment—would be welcome and might be expected given the transformation occurring in the economy and improved medium-term prospects. The statement by Messrs. Kiekens and Cserés suggests that this is in fact taking place.

Given the need for continued fiscal consolidation, the overruns in the social security accounts are a cause for concern. The deficit of the social security budgets are already triple the originally targeted level for the year. Could the staff provide some perspective to the degree to which some of the more recent remedial measures (e.g., tightening up pharmaceutical subsidies) will help correct imbalances. Regarding pension reform, it would be interesting to know whether thought has been given to a greater private role—particularly in the second pillar?

Mr. Esdar made the following statement:

We agree with the staff's assessment and would like to compliment the Hungarian authorities on the marked improvement in economic conditions based on macroeconomic stabilization and liberalization of the economy. The twin deficits in the fiscal and current accounts have been reduced considerably, and structural reform has gained momentum.

It is noteworthy, as Mr. Kiekens has reminded us repeatedly, that the significant reduction of the external debt was achieved without the crutches of rescheduling or other debt relief instruments. The strategy of structural reforms, fiscal adjustment, and liberalizing the economy has paid off, not the least as reflected in the positive growth rates since 1993. These successes once again demonstrate that adjustment efforts and growth performance are not necessarily contradictory, but that reasonable and convincing adjustment performance paves the way for improvement in economic conditions.

Hungary's positive overall performance has been honored by international rating agencies as well, which have upgraded Hungary's rating, as well as by the markets. This has contributed to a considerable decrease in interest premiums on Hungarian debt, thereby reinforcing the ongoing adjustment process. My authorities have supported the adjustment efforts through project financing of about DM 1 billion, provided by both the federal government and individual Länder.

However, notwithstanding the overall encouraging policy performance, there remain challenges and problems which have to be addressed. The main area of concern in this regard is certainly the stubbornness of inflation. And there is no doubt that additional efforts are required to improve the overall outlook.

We share the staff's view that it is crucial to bring inflation further down. An inflation rate of nearly 25 percent undermines solid economic development, in particular because of its negative impact on resource allocation and distribution.

We accept the fact that supply side factors such as increases in administered prices and wages have contributed to inflationary pressure. At least in the medium term, however, inflation is a monetary phenomenon which has to be addressed vigorously in order to prevent the buildup of entrenched inflationary expectations. The strong monetary growth in Hungary has certainly accommodated inflationary factors. The nominal anchor of the exchange rate peg has been less effective than expected, as noted by the staff.

A further tightening of fiscal policies, as discussed by the staff, would certainly be an appropriate response, especially because authorities have limited influence on wage policy. However, given the measures which authorities have already taken and the need to generate the necessary political and social consensus for the reform process, we acknowledge that the scope for further tightening might be limited. Therefore, we would like to reiterate our previous suggestion that monetary policy be given a stronger role in fighting inflation in the framework of a more flexible exchange rate regime. At the same time, this would relieve the central bank from sterilizing capital inflows, which according to the staff paper has generated significant quasi fiscal losses.

Finally, I would like to encourage the authorities to continue their reform efforts in order to further liberalize the economy and expand opportunities for private initiative and privatization. With these remarks, I have no problem supporting the proposed decisions.

Mr. O'Loghlin made the following statement:

The explanation for the shortfall in net international reserves compared with the end-June program criterion indicates that a waiver in respect of this variance is appropriate. Since the remaining performance criteria for end-June have been met—and it seems probable that purchases will not be necessary under the current Stand-By Arrangement—this chair is happy to support the decision proposed in the supplement and thus to complete the present review.

As I agree with the thrust of the staff appraisal I propose to confine my remarks to a few issues which, in my view, deserve emphasis.

First, the fact that underlying wage growth is running at 25 percent suggests that high inflation expectations indeed are becoming ingrained—following several years of price increases in the 20–30 percent range. The longer inflation persists at this level the greater the cost, in terms of output foregone, which is likely to be entailed in bringing it down. One can only hope that the reluctance of the Hungarian authorities to pursue a more restrictive fiscal stance at this stage in order to bear down on price pressures will not prove too costly in the longer run.

Second, this pace of wage growth seems inconsistent with maintaining the gains already achieved on the current account of the balance of payments—even with a monthly 1.2 percent devaluation of the forint. Bearing in mind that the improvement was supported by a temporary import surcharge and by the severe contraction in private consumption highlighted in Mr. Kiekens's statement, there must be substantial risk to the balance of payments as the latter influences unwind—unless wage growth is curtailed. Perhaps the staff might comment on this, in particular in the light of the strength of imports through the first half of 1996 which is mentioned in the supplement.

In addition to this concern, the demonstration effects of these private sector wage developments vis-à-vis public sector pay cannot be helpful to maintaining the necessary downward pressure on the fiscal deficit.

Accordingly, like Mr. Shaalan, I think it is unfortunate that the authorities have been reluctant to take a stronger stance on the fiscal front this year to counter above-program inflation, but have preferred to adjust their inflation targets. Since about half of the decline in private consumption over 1994/95 reflects a rising savings ratio there seems to be room for a more positive consumer outlook—which would be engendered by firmer action in the face of slippages—to dampen the short-run effects of fiscal action.

Finally, since the authorities do not intend to tighten policy further this year, I feel that the overall policy setting for 1997 may be too accommodative, in the face of this undesirable development of costs. The budgetary aim—despite further anticipated slippage on inflation as compared with the program objectives—is to maintain rather than to increase the primary balance. And the concept that forint depreciation should remain at 1.2 percent a month unless the balance of payments permits a reduction implies that the exchange stance will tend to respond to, rather than lead, wage determination.

Notwithstanding my comments foregoing I believe that the Hungarian authorities have been making strong efforts, for which they are to be commended. As I have already indicated, this chair supports the completion of the present review, and wishes Hungary every success in the task ahead.

Mrs. Gotz-Kozierkiewicz made the following statement:

The five-month period after the last discussion on Hungary in the Executive Board has brought a reconfirmation of the positive results of the ambitious and comprehensive program, dated March 1995, and its continuation through 1996. The achievements concern structural reforms as well as a substantial improvement in the fundamental economic macroproportions.

Both major policy packages have been thought conducive to sustainable export-led economic growth in the longer term. In the short to the medium term ahead, until the end of 1997, the assumed rates of output growth would have been very moderate. As for the 1.5 percent economic growth in 1995, it satisfied expectations both of the staff and the authorities. The first roughly estimated figure, close to 2 percent, probably prompted them to be more optimistic regarding growth dynamics to be expected in 1996–97, despite virtual stagnation in the second half of 1995. However, virtual stagnation appeared to be eventually a slight decline and the rates formerly assumed at 2 percent and 3.2 percent for 1996 and 1997, respectively, have been lowered afterward by 0.5 percent each, according to the present forecast.

Substantial changes have also taken place in the sources of economic growth observed in 1995 and projected for 1996–97. The rate of growth of gross fixed investment in 1995, previously estimated at 5.4 percent, actually came down to only 1.2 percent, whereas the respective figures for 1996 and 1997 have been increased from 8.8 percent to 11.8 percent and from 9.5 percent to 11.3 percent. Real exports in 1995 appeared to grow at a rate almost twice higher than provisionally estimated (15.4 percent instead of 7.9 percent). According to the present forecast, real export growth rates in 1996 and 1997 would amount to 12.9 percent (instead of 8.8 percent) and 9.8 percent (instead of 9.5 percent), respectively.

At the given stage, notwithstanding the much better results in exports in 1995, sluggishness of investment may be worrisome, as less promising for economic growth resumption in 1996, and also in the medium-term perspective. According to the staff's expectations, presumed "vigorous investment should be boosted by the sharp recovery of profits in 1995." My impression is that taking for granted the latter (I mean the sharp recovery of profits in 1995) may be somewhat misleading. The actual recovery, probably very moderate and unevenly distributed over the sectors of economy and enterprises, seems to relate also to the partial explanation of inflationary processes in 1995 and 1996.

Unfortunately, data on profit margins development in Hungary in 1995–96 were not published either in the staff report or in the background papers. The staff points to the fact that the wage compression in real terms in 1995 was exerting a strong positive impact on profit margins. Due to this impact, they have been supposed to increase from their level moderately recovered at the beginning of the year (this recovery took place in 1994) to a much higher level. This supposition has been based mainly on the indirect indicators of the trend, like the increased share of operating surplus in GDP and the improved performance of profit tax revenue.

A substantial increase in profit margins due to the wage compression would have to be true, with other major items in the costs of production being equal. However, there have been very substantial inter alia energy price increases in the meantime; it seems rather probable that these energy price raises have partly offset the cost reduction caused by the real wage effect. In some branches, the final result in terms of change in the profit margins could have been close to zero or even negative, depending on the structure of the particular production costs. It seems hardly deniable that on average, profit margins would have been still quite low in 1995. In such circumstances, to expect producers to be prone to their price reductions or relatively less price increase to adjust lower domestic demand in 1995 would seem somewhat unjustified. Counting upon the scale of production as offering better amount of profits would have been reasonable only in the case of demand for price flexibility much higher than the one potentially expected in the Hungarian economy in 1995. Therefore, it cannot be excluded that producers' behavior as observed, on the basis of price movements in the given period, had its source not so much in a relatively weak competition in the market, as supposed by the staff, but it could have been the result of a limited choice that the producers had in the given circumstances.

A situation might probably have been somewhat different in the export sector, as reflected in the relative quick pace of growth of the export volume. However, it also seems difficult to conclude about the level and dynamics of the profit margins in exports. There have been a number of factors contributing to export developments in 1995–96, complicating a clear judgment on its underlying profitability. First, the effect of relatively aggressive exporters' behavior to expand to the foreign markets under the circumstances of reduced domestic demand cannot be excluded. The impact of step devaluation and of the crawling peg as introduced since the second quarter of 1995 could also play its role. It would be helpful to learn about the trend in the terms of trade, as pointing to the real relative costs of the Hungarian export expansion. A hypothesis may not be rejected that many different factors working in the different directions on export profitability in 1995 finally brought to its level did not move far away from that in 1994; however, it was probably better than the one in production for the domestic market. The very low investment growth in 1995 does not confirm the hypothesis about high profitability of exports.

In my previous statement I pointed to the fact that the main factors underlying the development of inflationary processes in the period preceding March 1995 and in the period under the last programs have not been homogenous. Well established inertia, reflected in expectations of the yearly consumer price index increase at about 20 percent as the bottom line, and many different new shocks overlapping the inertial behavior of economic agents presumably contributed to the inflation acceleration in 1995–96.

The staff points, although not without some noticeable hesitation, to eventual tightening of the policy package, which might be helpful at attainment of the more ambitious (previously programmed) inflation targets or avoidance of further potential slippages in them. I would rather share the authorities' view that an attempt to suppress inflation by even more intensified efforts on the monetary and fiscal side would not seem to be the one well-balanced in terms of both its potential efficiency and its impact on real processes in the short and the medium-term period.

What should be of critical importance in Hungary at the present stage is keeping under control the developments in real wages. The presumed role of the exchange rate as a nominal anchor in 1995–97, with the devaluation targeted clearly below the inflation rate, would probably work as the well-known double-edged sword. On the one hand, it should be enforcing the so much required further down-side adjustment in the wages in the tradables sector. On the other hand, it may appear to be difficult and, in particular, with productivity growth in the range close to the assumed 2.0–2.5 percent, and some further expected domestic shocks to the costs of production, to achieve a sufficient export profitability in the period ahead until the end of 1997. It is worth to also recall that alongside a gradual probable slowing down in the producer price index relative to the consumer price index increase, the wage adjustment in real terms would appear more disadvantageous for producers' profit margins than in the case of both very similar price trends (like in the second half of 1995). Taking into account these reservations, a potential recourse to a reduction in the rate of crawl in the second half of 1995, as considered by the staff with the purpose to more efficiently anchor inflation, would seem a rather risky measure. Moreover, it would probably encourage speculative short-term capital inflows, adding problems linked to the costs of sterilization.

All in all, the main challenges facing the government in the near and a more distant future would be keeping up the very ambitious fiscal targets, even more difficult to be achieved in the case of relatively slow economic growth, and restraining wage increase as one of the measures essential for keeping inflation under control and on the declining trend.

Among the actions linked closely to the fiscal targets, priority should be given to the social security system and, in particular, the pension system reform. However, the task would be very difficult in view of the fact that the latter would bear fruit only in the longer perspective.

At the end of my statement, let me express my full appreciation for the staff's open and honest approach to the anti-inflationary policy questions and, especially for the analytical insight into the causes of inflation in the Hungarian economy in transition.

Last but not least, I would like to stress my belief that with the authorities' further strong commitment to implement stabilization and structural measures, and well-deserved support from the international financial community, the final results of the program under discussion would appear to be successful.

Mr. Guzmán-Calafell made the following statement:

The positive impact of the program of stabilization and reform implemented by the Hungarian authorities is evident in the evolution of a number of indicators. The authorities have succeeded in reducing significantly the size of the fiscal deficit and in accelerating the pace of structural reform. In this context, the current account deficit has declined substantially from the very high figures observed in 1994, net external indebtedness has been sharply reduced, and greater confidence in the economy's outlook has been reflected in larger capital inflows, reduced costs of external borrowing, and a more favorable assessment of Hungary's debt by international rating agencies.

While the headway made by the Hungarian authorities in improving the country's economic conditions is undeniable, progress in a number of areas has lagged behind. In particular, the Hungarian economy continues to be affected by a combination of low growth and high inflation rates.

Real GDP in Hungary fell by a cumulative 16 percent in the period 1991–93. Subsequently, economic activity has recovered, but output growth has fluctuated and the rates observed have been modest. Furthermore, the expansion of GDP has been supported mainly by the growth of exports and gross fixed investment, since private consumption fell in both 1994 and 1995 and a further 3 percent drop is projected for this year. In addition, employment levels have declined continuously since 1991. This combination of factors provides an idea of the social costs that have accompanied the adjustment process, and points to the danger that persistently low rates of growth may undermine social support for the program.

The situation is complicated by the fact that despite the modest rates of growth recorded and the decline in aggregate demand, inflationary pressures have persisted, and in fact little progress has been observed in this area over the last years. The authorities are projecting a rate of increase of consumer prices of about 21 percent in 1996. This figure is almost identical to the one observed in 1993, and while inflation is projected to fall in 1997, the growth of consumer prices is expected to remain high. The situation can be further complicated if contrary to current expectations capital inflows run higher than expected, a possibility that cannot be ruled out, as shown by the results of the first half of 1996 included in the staff supplement. In this regard, I wonder if the staff could elaborate on the likely impact on net capital inflows of the recent steps to further liberalize capital movements.

There is obviously no easy way out of this dilemma. The authorities' concerns about the impact on economic activity of a further tightening of the fiscal stance in the short run are understandable, especially in view of the modest rates of economic growth and the depressed state of domestic demand. However, they will need to gauge continuously the potential effect on confidence of the fiscal policy implemented, since a period of renewed uncertainty would be even more costly in terms of both inflation and economic activity. It is also worth noting that notwithstanding the progress made so far and the ambitious fiscal measures envisaged for 1997, attainment of the fiscal targets is by no means ensured and the staff very clearly points out the areas where the risks are more evident. In this regard, I was concerned by the staff's comment that in the past complacency has frequently followed periods of temporary improvements.

With respect to monetary policy, the authorities are maintaining an adequately prudent stance. As the staff points out, one of the major risks in the future in this area is related to the possibility of a surge in capital inflows. The nominal appreciation of the forint would be a natural response if this possibility were to materialize. Currently, the authorities do not favor this option in view of the risks it implies for the current account. However, if in the face of important capital inflows exchange rate policy is not altered, the authorities will have little option but to tighten further the fiscal stance.

The failure of the authorities to bring down inflation as programed is disappointing. The staff notes that while this phenomenon is not fully understood, inflation in Hungary has essentially an inertial character. Therefore, coping with this problem will imply long and sustained policy efforts. In this process, it is very important for the authorities to give adequate weight to lessons from recent experiences. More specifically, as explained in the background report, and in Mr. Shaalan's statement, the inflationary process in Hungary has been complicated in the past by the fact that economic policy did not use the margins of maneuver available to seek a sizable reduction of inflation, and instead modest targets were set.

In the area of structural reform, I have little to add to the staff's analysis and recommendations. But I welcome the determination of the authorities to deal with the policy slippages in this area, as evidenced by their reinforced commitments under the Stand-By Arrangement.

With these comments I support the proposed decision.

Mr. Tahara made the following statement:

The authorities' policy implementation is broadly in line with the program supported by the Stand-By Arrangement. It is welcome that many of the objectives of the 1996 program seem to have been accomplished, including improvement of the fiscal and external balances and the reduction of the unemployment rate. I commend the authorities' efforts.

Since my appraisal of the economic situation and content of the program remains broadly unchanged since the last Board meeting, I will just touch briefly on a few policy issues.

First, as the staff paper notes and as all of the previous speakers have pointed out, the most serious concern is the inflation performance, which was below program expectations. The authorities are arguing for a revision of the inflation targets for 1996 and 1997 to make them less ambitious. In this regard, it should be noted that the authorities' revised target for 1997 implies little progress on inflation from the second half of 1996. The adoption of an unduly unambitious target might undermine market confidence; however, the target should be reasonably realistic or the credibility of the program itself would be jeopardized. While some upward revision of the 1997 inflation target might be justifiable, the authorities should be urged to strengthen their policy implementation in order to keep any deviation from the original target as small as possible.

While the development of the overall fiscal balance so far remains in line with the program objective, the risk of fiscal slippages is significant, especially in the area of social security, and also depending on the outcome of the wage negotiations. In this respect I share the staff's view that the authorities should maintain the 1996 fiscal target and strictly implement the public expenditure policies of the program. The authorities should also be ready to implement corrective measures in the next few months, depending on the development of the social security balance.

With regard to 1997 fiscal policy, while noting the importance of preventing domestic arrears, I welcome the authorities' intention to adopt more ambitious cuts in expenditures and revenues.

On the monetary front, the recent decrease in the interest differential is a welcome development since it may allow a certain degree of freedom for the use of monetary policy for the purpose of inflation reduction. However, the authorities should continue to be cautious about a resurgence of capital inflow, which might undermine the inflation objectives. Regarding exchange rate policy, I share Mr. Esdar's view that the adoption of a more flexible exchange rate policy should be considered in light of the limited room for maneuver of fiscal policy to fight inflation.

As for structural policy, while I welcome the observance of most of the structural benchmarks, I am concerned about the delay in social security reform. It is encouraging to hear that the authorities are committed to obtaining parliamentary approval of the key pension and disability pensions reforms as prior actions for the second review. I hope they will make their best efforts in this respect.

Finally, regarding the requests to lower the net international reserve floor, I can go along with the staff's proposal. The modification is justified because of positive structural developments and because the revised ceiling still seems to be at a comfortable level. However, the level of international reserves should be closely monitored in light of the heavy dependence on international capital markets and the substantial debt service burden.

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

Ms. Zheng made the following statement:

It is encouraging to read this year's Article IV consultation paper on Hungary which left us with a different impression than after the previous consultation. Such differences obviously mark the significant progress in the fiscal and external sectors and the increase in savings made in only one year. The authorities deserve commendation for adopting strong adjustment packages along the lines of the Fund program which underpin their ability to achieve most of the program criteria. We also note such progress is rewarded in the market sentiment. However, I agree with the staff that further efforts to consolidate the economic achievements should be the main thrust of future policy, especially given the still weak economic activity and difficulty in breaking the inflation inertia.

The staff is correct in placing curbing inflation as the major policy task. Given the difficulty in understanding the possible components or the structural elements of inflation, it is safe to continue the restrictive fiscal and monetary policy combined with structural reform. As the inflation pattern is different from that in other transition economies which follow the big-bang approach, we view the main reason for the inflation inertia is that the structural reform remains incomplete.

It is evident that the fiscal deficit in 1995 decreased sharply from 1994, and will even be reversed to a slight surplus in 1996 according to the authorities' program. While reminding ourselves that the improvement in this data is mainly from the privatization receipt, the fiscal deficit, excluding this element, was as high as 6.6 percent of GDP in 1995. Therefore, it would be cautious to realize that the privatization receipts are usually a one-off benefit and are normally earmarked to expenditures related to enterprise reform, such as strengthening the social security system. Hence, privatization receipts should not be regarded strictly as pure receipts to the budget. Even with this element, I notice that improvements in fiscal performance are impressive for the primary balance in 1995 turned to some surplus, as a result of the package of fiscal measures, including wage moderation. The authorities' program for 1996 is more ambitious, and, if realized, could be a solid improvement over the past high fiscal deficit inertia.

On the monetary front, the strength of monetary tightening over the past year has been felt in the decline in private and collective consumption; fortunately, investment did not decline in 1995, explaining why growth was not hurt by the economic adjustment. Furthermore, I also share the staff's view that the interest rate decline should be handled in line with the inflation development. The authorities' skillful management should be commended in both connections. In view of the market's favorable reassessment of the Hungarian economy, the continued capital inflow will become a new economic challenge, especially by adding pressure to the still high inflation and fiscal sterilization cost. Therefore, it is worth preparing new strategies to address the issue. The current crawling peg exchange rate system seems to have worked well so far and it is reasonable that it be continued. Given that Hungary is still a nascent emerging market, it will be worthwhile to develop a policy to discourage the speculative capital. To this end, measures to strengthen the domestic banking sector and supervision will be of great help.

Structural reform clearly remains the key to completing the transition and gaining long-lasting economic stability. The gradual price reform of the past two decades, though slow, has, on the other hand, paved the way for the major progress in price liberalization from 1991, including liberalization of oil and food prices. It is worthwhile noting that price liberalization is not an easy task, for it will not only create shocks to different economic sectors, but will also require the building up of a supervision and administration framework, including a legal framework and supervision manpower and anti-profiteering mechanism, which usually take a long time. Therefore, the Hungarian approach also deserves study for the impact of its pattern of price liberalization on economic adjustment. Beyond this point, I agree with the staff that banking sector and enterprise reform are also important to tackle, and I fully share their proposals in this regard.

Finally, I wish the authorities further success in gaining long lasting economic stability. With these remarks, I support the proposed decisions.

The staff representative from the European I Department remarked that the authorities and the staff agreed that inflation was proving to be more deeply ingrained in the economy than had been expected. However, the exact reasons for the stickiness of inflation remained poorly understood. While it was true that the administered price increases in the first half of 1996 had been higher than expected—accounting for about half of the higher than expected inflation outturn—it was also true that the staff and the authorities had overestimated the role that the exchange rate anchor could play in moderating inflationary pressures in both the tradable and nontradable sectors. There had been a drop in demand in the nontradable sector, but inflation had continued owing to a number of rigidities in the economy, including an inflexible labor market, insufficient competition, rigid inflation expectations, and the uncertain size and effect of the informal economy on demand pressures, particularly in the nontradable sector. Given such stickiness, the staff agreed with the authorities that the original inflation targets for 1996 and 1997 appeared unrealistic. Also, the stickiness of inflation contributed to considerable risks—particularly for the external account—because the rate of crawl of the exchange rate could not be increased without damaging the authorities' credibility.

The staff believed that a tighter fiscal policy would have helped moderate inflation, the staff representative continued. In the event, political difficulties had impeded a tightening of fiscal policy; nevertheless, a deceleration of inflation would continue to rely on tight fiscal policies and an appropriate incomes policy. It was regrettable that the authorities had announced a revised preliminary target for inflation for 1997 as high as 17–18 percent, because that might serve to inflate expectations. However, the authorities had pointed out that the final target for 1997 might be revised downward if inflation decelerated over the following months. The staff continued to believe that an inflation target for 1997 of 15–17 percent could be achieved within the current monetary and exchange framework.

Mr. Shields asked what effect the removal of the import surcharge and the postponement of the energy price increases would have on inflation.

The staff representative from the European I Department responded that the removal of the import surcharge would have some positive effect on inflation in the second half of 1996, but mostly in 1997; that effect had been taken into account in the staff's projections. The postponement of the increases in energy prices merely shifted the inflationary impact by three months and would not affect the average inflation rate. However, the postponement had negatively affected the authorities' credibility, because it created uncertainty about the timing of the increases; also, enterprises had already assumed that the increases would occur in October 1996 and had adapted their business plans accordingly.

The staff, while not being dogmatic on the issue, shared the authorities' concerns that a more aggressive exchange rate policy—through lowering the rate of crawl or adopting a floating exchange rate—would involve some appreciation that might negatively affect the external account and growth, the staff representative said. It was important to recall that Hungary continued to have a significant current account deficit—about 4 percent of GDP—and a high level of external debt, especially in relation to other transition economies with similar underlying demographic characteristics. A more aggressive exchange rate policy would expose Hungary to the risk of missing both the external and growth targets. Also, the current rate of crawl could provide sufficient stimulus for the continuation of the disinflation process. Indeed, the current exchange rate policy had been delivering positive results in 1996, with the current account declining as expected and inflation decelerating. Moreover, the prospect of shifting to a new anchor was complicated by the continuing instability of money demand. Nevertheless, if capital flows were to increase in the future, then the authorities should widen the exchange rate band instead of allowing inflation to rise.

Mr. Esdar noted that there remained some questions regarding the appropriateness of the current monetary and exchange rate policies. The staff report stated that the exchange rate anchor had not performed as well as expected, and there was no other monetary anchor in the program to combat the stubbornly high inflation rate. While it was true that money demand was unstable, that did not mean that appropriate monetary policies could not be used to counteract inflation. The challenge was to develop procedures to help guide monetary policies in countries like Hungary with the problem of persistent inflation.

The staff representative from the European I Department remarked that the staff believed that, given the current exchange rate regime and the rate of crawl, inflation would continue to decelerate. The fact that inflation was more entrenched than expected did not necessarily mean that the current exchange rate regime was mistaken. Also, monetary policy had been, to a large extent, flexible, and it had succeeded in keeping real interest rates positive in early 1996.

Mr. Kiekens made the following statement:

I would like to make some additional remarks concerning the issue of inflation and the exchange rate. I would like to draw the attention of my colleagues to the fact that I continue regard my authorities' inflation target as ambitious. Indeed, their goal is to reach a rate of underlying inflation of 10 percent by the end of next year. It is always risky to make comparisons between countries, especially countries within one's own group, but if this particular objective can be realized, Hungary's underlying inflation will be at the same level as the Czech Republic's. In fact, as the staff has noted, inflation is now about 4 percent higher than expected, and half of this is due to the larger than expected increases in administrative prices. The planned deceleration of inflation is still there, as shown by the objective for the last quarter of next year. What has happened is that the deceleration curve has been delayed about three to six months because of these administrative price increases. The Board's discussion gives the impression that the Hungarian government is only accommodating this excess inflation without adjusting its policies. But in fact, they are tightening their policies.

First, the import surcharge is being phased out sooner than planned. This is a very welcome decision. On an earlier occasion, I criticized another country for delays in the phasing out of import surcharges. Second, the staff is advocating a tightening of fiscal policies, and my authorities are doing this in two ways. First, primary expenditures will be cut next year by an additional 2 percent. This will realized through additional structural reforms, which Mrs. Cheong rightly identified as critical for the anti-inflationary process. Second, instead of the $100 million initially agreed upon, privatization revenues will henceforth be used in their entirety for debt reduction.

I agree with my authorities, and with the observations of several colleagues including Mr. Ryan, that changing the nominal anchor would not have been appropriate only 12 months after the launching of this so far successful program. Credibility cannot be earned overnight; it needs stability in the process and faith that strategy chosen will be effective over time. It has been said, by the staff and some Board members, that the nominal anchor seems not to have worked as well as was hoped. I believe it is too soon to come to this conclusion, because 50 percent (in the staff's figures) of the excess inflation was caused by unscheduled administrative price increases. This indicates that, for the time being, the nominal anchor should not be considered as ineffective.

Mr. Esdar said that he can understand that the tightening of the fiscal policies has its limits and that there is little scope for further tightening under present circumstances. Indeed, the latest *World Economic Outlook* reveals that Hungary will have the lowest fiscal deficit among all the transition countries in 1996 if the comparison includes, as does the staff's comparison in the *World Economic Outlook*, the revenues of privatization. Ms. Zheng said we should not consider privatization revenues when assessing the fiscal position. My authorities accept this view, and will use the privatization revenues entirely for reducing the external debt.

Mrs. Gotz-Kozierkiewicz said that she believed that the crawling peg exchange rate regimes employed by other transition economies had not been as successful as had been anticipated. Over the medium term, some real appreciation had taken place and a steep devaluation had been necessary. Much of the difficulty had been caused by domestic sources of inflation.

The staff representative from the European I Department commented that the current rate of crawl was sufficient to maintain competitiveness and to achieve the current account target. Productivity growth was strong, particularly in the tradable sector, and the expected cuts in social security contributions in 1997 would lower unit labor costs. As a result, and even with the higher than expected inflation rate, competitiveness should improve sufficiently to offset the effect of the removal of the import surcharge; however, the margin of risk had been increased.

Various indicators of the profitability of firms suggested that profits had increased since 1994, the staff representative continued. However, it was difficult to compare those profit margins with past performance owing to the significant changes that had occurred recently in the economy.

The liberalization measures implemented in July 1996 should not have a significant net effect on the level of capital inflows, the staff representative noted. That liberalization mostly concerned the banking sector, especially permitting banks to increase their gross borrowing and lending vis-à-vis nonresidents. Moreover, the interest rate differential—currently at about 5 percent—was close to its equilibrium, taking into account the risk of depreciation within the exchange rate band; that was not likely to attract further capital inflows.

On the fiscal implications of the social security reform, the staff was encouraging the authorities to accelerate the pace and extent of reforms during the second half of 1996, the staff representative stated. It was expected that the collection of social security contribution arrears would improve and the level of social security contributions would increase because of the higher wages paid out in the public sector. The staff was suggesting that the authorities take additional measures, including restricting access to medical cards that provided free access to pharmaceuticals and creating some room in the central budget to offset any further slippages in the social security budget. Also, the role of private pension funds should be enhanced after the comprehensive reform of the social security system, scheduled for end-February 1997.

Mr. Mozhin made the following statement:

The current Hungarian stabilization program began in 1995 and was supported by the Fund almost a year after its reasonably successful implementation. Since then, there have been no serious setbacks, and I am pleased to commend the Hungarian authorities for their perseverance and determination. The most spectacular success has been achieved in the fiscal area, which is the most difficult to deal with and the most crucial for the eventual success of the program. It is expected that by the end of 1996, the expenditure-to-GDP ratio of the consolidated government will decline by some 9 percentage points compared to 1994. This decisive fiscal consolidation has already led to a steady improvement of the public debt level and a reduction in debt service payments.

Under the circumstances of suppressed domestic demand, exports have become the most dynamic sector of the economy, and export growth in excess of 10 percent in both 1995 and 1996 should be viewed as evidence of the program's success. I do not think one should be surprised or excessively concerned by slow overall output growth in the first two years of the stabilization effort, as the GDP aggregates conceal quite healthy changes in their composition. At the same time, some deviation of the inflation performance from program targets is understandable, though not welcome. Obviously, economic theory has no means to predict actual price behavior with a precision desirable for policymakers, especially during the turbulence of economic transition.

Inflation remains broadly within a range envisaged under the program, and its downward trend seems to be well established. Nevertheless, continuous efforts aimed at bringing inflation further down are clearly needed. In this respect, I welcome the authorities' decision to accelerate the phasing out of the import surcharge.

As inflation remains a major concern, the authorities could look again at their exchange rate policy. As this chair noted during our previous discussion on Hungary in March 1996, the crawling peg system adopted by the Hungarian authorities leaves room for entrenched inflationary expectations that might be difficult to dispel. A continuation of the policy of monthly exchange rate depreciation of about 1 percent might lead Hungary into a situation of chronic inflation of, say, 15 to 25 percent a year, mainly as a result of gradually institutionalized indexation. The authorities' concern about external competitiveness, which makes them unwilling to consider a reduction in the rate of crawl, does not seem to be supported by the buoyancy of the export sector. Messrs. Kiekens and Cserés are correct to point to some factors, such as reverse currency substitution and large capital inflows, that make monetary programming in Hungary rather complicated. Under these circumstances, any rate of crawl can only be arbitrary and subject to political pressure.

On structural issues, the program contains many conventional tasks, such as public service retrenchment, continuous privatization, and the creation of a treasury system. Perhaps the most far-reaching task is the reform of the pension system along the lines of the three-pillar model developed by the World Bank. It remains to be seen to what extent the authorities will find it feasible to develop all three pillars simultaneously. In fact, one could argue that limited administrative capacity and the still difficult fiscal situation warrant the fully private pillar to be given more weight. In any case, a comprehensive streamlining of the existing generous and redistributive pension system should be a priority.

With these remarks, I support the proposed decision and the request for a waiver of the reserve criterion. In fact, I see the decision to liberalize capital account operations that eventually led to the nonobservance of the reserve criterion as a positive step.

Mr. Santos made the following statement:

Hungary has come a long way since the beginning of 1995, when it faced very large fiscal and external current account deficits. The adjustment in external accounts has primarily reflected a combination of wage moderation—instrumental in strengthening competitiveness—fiscal consolidation and a related improvement in domestic savings. For 1996, available information indicates that the objectives for the fiscal and current account deficits are very much within reach. However, due to higher-than-anticipated increases in administered prices and excessive wage increases in the nontradables sector, less directly influenced by the discipline of the crawling peg, inflation deceleration has come up short of the program goal. More importantly, the perception that inflation is not decelerating as expected may lead to a reversal of the improvements in confidence, and wage claims throughout the economy, both in the tradables and nontradables sector, may be revived, thus contributing to the erosion of competitiveness with serious implications for the sustainability of the real adjustment.

In this context, we would have welcomed the adoption of a slightly more ambitious inflation target for 1996. Although such an approach would have involved a reduction in the rate of crawl, with the consequent increase in risks for the external current account, as the authorities pointed out, the adoption of a fairly unambitious target also exposes the external accounts to risks. Indeed, given the authorities' intention to pursue a prudent monetary policy, inflation inertia might lead to the persistence of a higher interest rate than would be desirable, and consequently, to higher capital inflows and costs of sterilization.

Given the limited room for maneuvering monetary policy, fiscal policy becomes a key instrument of macroeconomic management. In this respect, we commend the authorities' decision to keep a tight fiscal stance in 1997 and to use the proceeds from privatization during 1996 to reduce government debt.

Mr. Shields made the following statement:

Like others, I am pleased with the progress Hungary has made recently, particularly the good fiscal adjustment, the improvement in the current account deficit, and some renewed growth. But in some respects, things have not worked out as anticipated. For example, I wonder about the balance between what the Hungarian authorities are doing and wish to do, and the role of the Fund itself. There is a note of disengagement or distance in the staff papers and in the comments we have heard about Hungarian policy. Sometimes that is good, because clearly the program is Hungary's own, and that ownership is crucial to it's success. But the flip side of that, clearly, is that there may be some worrying things happening, and our input into the process is perhaps not as great as it should be. That is reflected, for instance, in the fiscal target presented for next year—an ambitious-looking target. I hope there could be closer involvement in the structure and the ambitions of such targets. Another place that such disengagement is reflected is in terms of the layout of the staff report, where we see the authorities' projections for 1996 and 1997. The staff concurs with the 1996 projections, and says next year's projections will depend on the budget that is passed. But it might have been useful to see an explanation of why the significant changes were made in the projections since the last staff report. We have talked about changes in inflation, but there are changes within the current account, particularly on the import side, and we had a fairly optimistic projection last time for investment growth, which has risen even further in the latest report. Also, there is a large downward revision to the debt service forecast. I wonder if the staff is content with such revisions.

I urge the Hungarian authorities to strive for a more ambitious inflation objective—down to 10 percent by the end of 1997. Looking at the actual experience of the last few years, it is difficult to believe that such a goal will be reached based on current policies, or that the authorities are committed to realizing it. There seems to be an acceptance of a continuation of the current, fairly high inflation rate. I understand the concerns about structural problems and the difficulties of using the traditional macroeconomic tools to bring inflation down, but I think that it would be better if there were a stronger commitment by the government and stronger attempts to secure public support for a policy of lower inflation. I would not recommend any change in the exchange rate regime at present, but moving toward a lower rate of crawl might be one way of giving a clear signal on inflation and supporting downward pressure in prices in the traded goods sector.

Mr. Al-Turki made the following statement:

Hungary's overall performance under the Stand-By Arrangement has been very encouraging. Nevertheless, a number of risks remain. I can generally endorse the staff appraisal, and will make only two general remarks:

First, the high rate of inflation continues to be a source of concern. The authorities' continued restraint in managing interest rates is most appropriate. Recent declines in interest rates in Europe could further ease pressures. However, without a substantial decline in inflation at an early date, the external situation will likely remain delicate. The authorities need to keep exchange market developments under close review to ensure that the exchange rate will serve as an element in disinflationary policy without allowing for a significant buildup of exchange pressures. This being said, the role of exchange rate policy in the authorities' strategy seems circumscribed by the apparent large size of the informal sector in the economy.

Second, the success of disinflationary policy will ultimately depend on the success of fiscal and structural policies. Reducing the overall role of the state must remain a foremost priority over the medium term. Progress in fiscal consolidation has been very encouraging, and the authorities ought to be commended for the ambitious cuts envisaged in revenue and expenditures. The slow pace of some structural reforms, however, is unfortunate. While the difficulties in this area are clear, Hungary remains vulnerable to market sentiment. Perceptions of delays could risk some of the hard-won gains.

With these remarks, I support the proposed decision and wish the authorities continued success.

Mrs. Paris made the following statement:

It is fair to recognize the important results that have been achieved under the stabilization program adopted in 1995. Current and fiscal deficits have been substantially reduced, and the external debt decreased noticeably. The acceleration of the privatization process is remarkable, and the authorities' commitment to pursue fiscal consolidation in 1997 is also commendable. Yet, I share the disappointment and concern expressed by previous speakers with regard to the stickiness of inflation, which could pose a serious threat to the success of the adjustment program.

Although recent decisions of the government to postpone the increase in energy prices until next year would, in effect, limit inflation results in 1996, I have doubts, like the staff, about the overall positive effects of such measures. More broadly, I remain unconvinced of the appropriateness of the current exchange rate policy, which has not yet proven effective in lowering inflation expectations. Like Mr. Esdar, I tend to believe that a tighter monetary policy to fight against inflation would be worthy of consideration.

Progress toward implementation of structural reforms is crucial to sustain durable growth, and here I particularly refer to welfare reforms. While delays in the adoption of the health and pension reforms are regrettable, I appreciate the fact that the implementation of the next step regarding pension reform will be viewed as a prior action for the completion of the second review. Given the important role of the World Bank in this area through the expected public sector adjustment loan, I would be pleased if the World Bank representative could provide an update about the preparation of this operation.

As for the pension reform itself, could the staff outline the cost of the transition from a pay-as-you-go system to a multi-pillar system? In particular, has the staff already discussed with the authorities how the fiscal burden will be financed—through public indebtedness, tax increases, or spending cuts? In that connection, while I pay tribute to the staff for its useful presentation of the envisaged reform in the background paper, I believe that one should be careful in claiming that such a reform will have a positive impact on savings. One should recall that, while private savings would increase, public savings in the absence of additional fiscal consolidation measures would decrease, so that it would be difficult to assess the impact on total savings; in that context, Chart 21 on page 74 in the Selected Issues paper (SM/96/207) may be misleading. With these remarks, I support the proposed decision.

Mr. Andersen made the following statement:

Hungary has been among the forerunners in the race from a centrally planned and regulated economy toward a market economy. Success in this race requires endurance, and I am happy to note that the Hungarian authorities show no signs of fatigue so far. The success includes the efforts under the current stabilization program, supported by a precautionary Stand-By Arrangement, and I can easily support granting the necessary waiver which in no way is due to any slippage in program implementation. The authorities deserve to be commended for their efforts and for having improved the macroeconomic situation markedly during the last 1½ years, especially for the significant reduction of the twin deficits in the current and fiscal accounts.

As the program has been successfully implemented, and as the results produced by the program broadly have been as expected, it might be sufficient simply to urge the authorities not to lose the momentum in their endeavors and to stick to forward-looking policies.

However, as noted by previous speakers, it is a matter of concern that inflation has proved more stubborn than anticipated, and the risk of too high double-digit inflation becoming entrenched in the economy appears to be the main shadow casting over the Hungarian economy for the time being. As noted in the more general analysis of inflation aspects in a special chapter in the World Economic Outlook papers to be discussed next week, there is strong evidence of a negative relationship between inflation and long-term growth, even at moderate inflation of 10 to 30 percent, which is the range Hungary is expected to be within in the period ahead, even though on a downward trend. To this comes the risk that inflation may even rachet upward if left unattended.

Unless the inflation problem is tackled speedily and decisively, inflation threatens to erode the hard-won gains when it comes to wage formation and competitiveness. While I am delighted to see that the authorities remain committed to a significant lowering of inflation in the period ahead, I too was disappointed to note that the authorities have chosen to adjust their inflation objectives upwards both for this year and for 1997, rather than implementing a significant policy tightening, especially regarding fiscal policy. Several Directors have made reference to, i.a., Estonia as another successful transition economy where there is a similar risk that inflation will become entrenched at a too high level. I don't disregard such a risk, but I would like to remind Directors about Estonia's very significant tightening of the fiscal policy.

The need for fiscal policy tightening in Hungary is all the more important considering the still significant risks that the fiscal target for 1996 will not be met. In this respect I am, in particular, worried about the dramatic widening of the social security deficit. The focus on fiscal policy also follows from the fact that the room for maneuver of monetary policy is limited and that incomes policies have their limits as well. Moreover, even if there undoubtedly still are some remaining structural rigidities that need to be addressed, one should probably not expect any dramatic results regarding inflation reduction from that front either.

Accordingly, the alternatives to fiscal consolidations are few, but I can see a combination of further fiscal consolidation and modification of the exchange rate policy as part of an appropriate policy mix to reduce inflation and inflation expectations further. I don't exclude that Mr. Esdar's suggestion could have some merits in the Hungarian case, but it may be too risky to change the anchor too frequently. Furthermore, there are the problems associated with the unstable money demand. As an alternative, I would rather side with those who would urge the authorities to consider a significant reduction of the rate of crawl of the exchange rate, thereby reducing the inertial component of inflation coming from the exchange rate, and I do not necessarily see any serious risks for the competitiveness situation from such a policy mix if it succeeds in changing the expectations and, in particular, in bringing the wage demands of the private sector down. In this connection, part of a further tightening of fiscal policy may also involve an even sharper curtailment of wage increases in the public sector, which could have an important signal effect. Needless to say, it will also be important to support such a policy with the keeping of a sufficiently tight monetary policy. To sum up, I think that some modification of the exchange rate policy could play an important supplementary role in reducing inflation further, but it cannot, of course, stand alone, as it is the commitment of the authorities to disciplined fiscal and monetary policies that is necessary for the control of inflation in the end.

The staff representative from the European I Department noted that the staff and the Hungarian authorities had cooperated closely, but that had not precluded the possibility of differences in views. While those differences had not been major, the staff had been explicit about what they thought was necessary to achieve the targets in the program. For example, on the issue raised by Mr. Shields regarding the frequency and extent of data revisions, the staff had highlighted that important statistical improvements—particularly in the areas of national accounts and fiscal developments—needed to be made, and some improvements were already visible. The large revision for investment growth in 1995, however, would not imperil the current projection for investment in 1996.

On the pension system and the financing of the deficit, the so-called second pillar, which would be fully funded, would aim to generate sufficient savings to finance the so-called first pillar, as well as increase the net saving of the pension system, the staff representative said. Such a system would be similar to those found in some industrialized countries, such as Finland, where the general government deficit was relatively low, because it included the savings of the so-called second pillar.

The staff representative from the World Bank explained that the proposed public sector adjustment loan would be considered by the Bank Board in March 1997, provided that the Hungarian Parliament adopted the framework law for pension reform. The Bank loan project had five components. The first component was pension reform, and the parliament was set to adopt the legislation by February 1997. The second component was the reform of the health finance system, which was less advanced than the pension reform plan. The targeting of social assistance was the third component, and the authorities hoped to generate some financial savings in that area. The fourth part consisted of the improvement in the management of public finance, including the implementation of the new treasury system. That was progressing well and was planned in parallel with a public finance project designed in close collaboration with the Fund staff that would be considered by the Bank Board in the autumn of 1996. Finally, the improvement of the tax administration authority was also planned.

Mr. Kiekens made the following statement:

> Let me complement the observations of the staff representative on the relations between the staff and my authorities. I can confirm to my colleagues that my authorities much appreciate their cooperation with the staff, and consider the exchange of views very constructive and helpful.
>
> I was present in Budapest when the staff mission was checking whether the program was on track. The staff did that very meticulously, as I could see by attending some very technical discussions.
>
> I should say that the Fund's involvement in Hungary since the new government took office in mid-1994 has been a success. Recalling our last discussion on Turkey a few days ago, I would indeed be very pleased to see the same success in Turkey, in terms of the orderly adjustment of a very critical situation and outlook. It was through the analysis of the staff that my authorities in Budapest found the determination to implement this very difficult and courageous program. I am therefore pleased to express their gratitude for the staff's very fine work.
>
> The latest *World Economic Outlook* contains an interesting chapter on the growth potential of the transition countries. It begins with the observation that "the resolve of policymakers to persevere with the necessary reforms, and

public support for the reform process, cannot be enhanced or even maintained unless benefits are forthcoming." For Hungary, these benefits are in fact forthcoming. As I pointed out in my introductory statement, one of the most important of these benefits is a dramatic reduction in the risk premium on Hungary's external debt, which remains very high. At a recent Board meeting, it was observed that Turkey benefited from a low risk premium of 350 basis points. And during the latest Board discussion on Mexico, a premium of 250 basis points was considered a major success. Hungary now has a risk premium of less than 100 basis points. Accordingly, I can confirm that this positive outcome has increased my authorities' determination to continue their strict implementation of the program, despite the existence of risks. One of these is that the popular support, crucial to the continuation of these successes, could evaporate if growth is not seen to be picking up. The staff's medium-term scenario clearly shows that growth is in the offing, but so far strong growth is not yet visible. That is certainly a main reason for the Hungarian authorities' reluctance to undertake a significant further tightening of fiscal conditions. However, I recall the steps I mentioned earlier that they have taken to tighten the program.

Mr. Shields, Mr. Andersen, and others have commented on the fact that the electricity price increase is to be postponed for a couple of months. This is true. The main reason is probably not connected with fine-tuning inflation, and I hope that the staff can confirm that. In fact, being the last in a series of adjustments of electricity prices, the present increase requires a lot of technical work which the authorities were not capable of accomplishing when the program was launched. This final increase was originally scheduled to occur during the latter part of this year, but given the results of their technical studies, the authorities decided, I believe in consultation with the power sector, to postpone the increase for a couple of months.

Other Directors have observed, and my authorities agree, that one of the problems is that privatization, especially in the utilities sector, has created monopolies. For the moment the clearest example is seen in the telecommunications sector, where the authorities were somewhat surprised by the high price rises, which probably occurred for lack of sufficient competition.

On exchange rate strategy, I personally agree with the view that it would have a good demonstration effect if the rate of crawl could be slowed in the coming months. My authorities are indeed seriously considering doing so if the external account and the inflation are satisfactory in the coming months.

In ending, I would like to confirm that my authorities are looking forward to the summing up of this Board's discussion. I thank my colleagues for their interest, support, and constructive advice.

The Acting Chairman stated that the recent change in the prospects of Hungary had been remarkable. It had gone from a country for which there had been considerable concern about the viability of the current account position, to a country for which that concern had vanished. That adjustment had been successfully completed with continued political support.

The Acting Chairman made the following summing up:

Executive Directors were in agreement with the thrust of the staff appraisal. They welcomed the marked improvement in macroeconomic conditions in Hungary since the last Article IV consultation in early 1995. The fiscal and external current account deficits had declined sharply, structural reform had gained momentum, and the stronger external performance had facilitated a sizable decline in net external debt. Those achievements resulted from the authorities' strong adjustment efforts and were being rewarded in international financial markets. Moreover, Directors observed that the rebound in exports had made positive economic growth possible, despite a sharp contraction in domestic demand. Progress on the inflation front, however, had been disappointing, and Directors highlighted the risk of persistently high inflation to the adjustment program. They therefore regretted the authorities' decision to raise their inflation targets rather than to tighten policy. They cautioned that the entrenchment of inflationary expectations could undermine the progress achieved thus far, and they urged the authorities to strengthen policy implementation to break inflation inertia, and to aim for a more ambitious inflation target for 1997. That required tight financial policies, structural reforms to alleviate supply constraints and enhance competition, and wage moderation.

Directors welcomed the authorities' continued commitment to fiscal consolidation and, in particular, to the targets for 1996 and 1997, which build on the commendable decline in the expenditure/GDP ratio since 1994. Indeed, most Directors supported a further tightening of fiscal policy. They stressed that, in light of the slippage in inflation, it was essential to achieve, as a minimum, the 1996 deficit target of 4 percent of GDP. In that regard, Directors pointed to a number of risks that threatened the attainment of the target. They expressed particular concern about the social security deficit, which in the first half of 1996 was already double the original target for the full year because of delays in structural reforms, especially in health care. Directors urged the authorities to take corrective action promptly if revenues from consumption taxes and the recovery of social security arrears did not pick up as the authorities expected.

With regard to the preliminary budget guidelines for 1997, Directors welcomed the authorities' intention to adopt more ambitious cuts in primary expenditures and tax rates than originally envisaged, and they encouraged the authorities both to make specific proposals concerning expenditure cuts and to broaden their scope. Directors warned against optimistic assumptions on higher tax collection in the short run stemming from improvements in tax administration.

Directors observed that capital inflows had complicated the implementation of monetary policy. While the decline in the interest rate differential could lessen capital inflows, Directors cautioned the authorities not to underestimate the potential for continued capital inflows and the need for, and the cost of, continued sterilized intervention. Some Directors suggested that a more flexible exchange rate policy could be considered as a key element of an anti-inflation strategy. Others, however, pointed to the risks to credibility of altering the exchange arrangement, which had been in effect for only about a year, and the shifting money demand that made monetary anchoring difficult. They stressed the need to tighten fiscal policy to reduce the burden on monetary policy. Some Directors also suggested a reduction in the rate of crawl to reduce inflationary expectations. Directors stressed that further declines in official interest rates should await clear signs that inflation was on a declining trend.

Directors emphasized that the successful implementation of structural reform would be a prerequisite for strong macroeconomic performance in the medium term. Important steps had already been taken, most notably a marked acceleration of the privatization process and an increase in the retirement age. However, the delays in health and pension reforms, and the larger than programmed deficits in the social security budget in the first half of the year, were worrisome, given their implications for the fiscal consolidation process. In that respect, Directors welcomed the authorities' intention to obtain parliamentary approval of the pension and disability pension reforms prior to the second program review.

Directors welcomed the recent reduction of the import surcharge ahead of its original schedule. They also welcomed the further liberalization of capital account transactions since July 1, 1996.

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

The Executive Board took the following decision:

1. Hungary has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Hungary (EBS/96/18, Sup. 2, 3/18/96) and paragraph 6 of the letter of the Minister of Finance and the President of the National Bank of Hungary dated February 2, 1996.

2. The letter of the Minister of Finance and the President of the National Bank of Hungary dated August 5, 1996 shall be attached to the Stand-By Arrangement, and the letter dated February 2, 1996 shall be read as supplemented and modified by the letter dated August 5, 1996.

3. Accordingly, the performance criteria set out in paragraphs 3 (a)(i), (ii), (iii), (iv), (v), and (vi) of the Stand-By Arrangement for September 30 and December 31, 1996 shall be as specified in Annexes I, II, III, and IV attached to the letter dated August 5, 1996.

4. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement for Hungary is completed and that Hungary may proceed to make purchases under the Stand-By Arrangement, notwithstanding the nonobservance of the performance criterion set forth in paragraph 3(a)(iii) for June 30, 1996.

Decision No. 11328-(96/80), adopted
August 28, 1996

2. BENIN—1996 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1996 Article IV consultation with Benin and Benin's request for arrangements under the Enhanced Structural Adjustment Facility (EBS/96/127, 8/12/96). They also had before them a policy framework paper for the period 1996 99 (EBD/96/105, 8/12/96), together with a background paper on recent economic developments in Benin (SM/96/215, 8/14/96).

Mr. Koissy made the following statement:

Benin has made substantial progress in restructuring its economy through a successful implementation of financial and structural policy measures within the framework of SAF- and ESAF-supported programs since 1989. During the period of the third annual arrangement under the ESAF, which ended in March of this year, economic performance further strengthened. In

1995, the rate of growth of real GDP reached 5 percent; the rate of inflation fell sharply from 54 percent in 1994 to 3 percent at the end of the year. Progress was also achieved in the area of structural reforms, enabling the private sector to play a more important role in the economy. However, the external current account deficit widened from 5 percent of GDP in 1994 to 8.6 percent mainly because of a sharp rise in imports of capital and intermediate goods in response to a strong increase in investment activity.

Following the election of a new President in March 1996, the government has reiterated its determination to pursue the adjustment efforts already under way, putting more emphasis on the need to achieve high quality growth that will contribute to poverty alleviation and employment creation. At the same time, the government intends to improve the provision of basic social services in health and education, while creating an environment that would enable Benin to increase its domestic savings, and thus make domestic investment less dependent on external financial flows. The design of financial and structural policies, envisaged for the period ahead, takes these broad objectives into account.

For the 1996–99 period, the main objectives of the economic program include: the achievement of a rate of real GDP growth of 5.5 percent per annum; the reduction of the rate of inflation, measured by the GDP deflator, at less than 3 percent; and a reduction of the external current account deficit to about 5.5 percent of GDP in 1999. To achieve these objectives, fiscal measures contemplated by the authorities aim at bringing the overall deficit, on a commitment basis, down from 7 percent of GDP in 1995 to 5.4 percent of GDP by 1999. This would raise the primary balance surplus from 2.2 percent of GDP in 1995 to about 3 percent in 1999. Achieving these results would help the country to reduce its debt-to-GDP ratio and increase domestic savings. To this end and to support the country's adjustment efforts, however, substantial financial assistance is needed from external sources, including the Fund.

Within the medium-term framework, the first annual program, covering the period July 1996–June 1997, aims at achieving a real GDP growth rate of 5.5 percent; limiting consumer price inflation to about 4 percent; and reducing the external current account deficit by about 1 percentage point of GDP. Production and price trends observed during the first half of this year show that both the growth and the inflation objectives are achievable.

In the fiscal area, the strengthening of Benin's fiscal position remains the main focus of the authorities' program. Despite a programmed increase in social outlays (health and education) and public investment, including externally financed projects, the overall fiscal deficit, on a commitment basis and excluding grants, is projected to fall from 7 percent of GDP in 1995 to 6.2 percent of GDP in 1997. Consistent with this overall target, the first-year program's fiscal target is to maintain the primary surplus at 2.2 percent of GDP in 1996 and to raise it to 2.5 percent of GDP in 1997. government revenue is projected to increase despite a decline in taxes levied on the cotton sector over the 1996–97 period. The revenue shortfall expected from the reduction in implicit taxation of cotton farmers will be more than offset by a further elimination of exemptions on customs duties; an increase in the taxation of cement; and the introduction of a new taxation system of petroleum products.

As regards government expenditure policy, the first annual program envisages substantial increases in resources allocated to social sectors and operating expenditure as well as investment outlays. Public investment spending is programmed to increase by 20 percent between 1995 and 1997 or the equivalent of 0.3 percent of GDP. At the same time, a tightening in wage policy is programmed for 1997. The government has decided to introduce a new system of wage increases which will be based on merit. It is expected that this new system will become effective in February 1997. The restraints in wage increases will create favorable conditions for the recruitment of teachers and nurses whose numbers have been declining steadily since 1989. The reduction in the fiscal deficit ,on a commitment basis, together with expected external assistance, will put the government in a position to repay domestic arrears during the next two years, repay the frozen deposits at the liquidated banks, and accumulate deposits with the domestic banking system.

The main objective of monetary policy is to achieve price stability. Benin's monetary program aims at reducing the level of net credit to the government in 1996 in order to provide adequate room for an increase in credit to the economy that will be consistent with the objective of increasing the banking system's foreign assets in an amount equivalent to 15 percent of the money supply at the end of 1995.

Apart from these quantitative targets, the authorities intend to strengthen the functioning of the banking sector and its financial intermediation. In that context, the authorities strongly support the regional banking commission in its supervisory role in Benin. Other initiatives taken by the monetary authorities, include the strengthening of the network of mutual and cooperative savings and loan institutions, as well as the development of a new regional financial market.

On structural policies, the main objective of my authorities is to assign a more important role to private sector activity, while promoting the diversification of the economy and the exports base. To this end, a number of actions are being taken by the authorities, including an improvement of the tax and legal framework and a strengthening of the judiciary system. Efforts are also being made to restructure a number of enterprises. For example, the activities of the Port of Cotonou are being restructured. Other enterprises to be restructured are the palm oil company (SONICOG) and the social security agency (OBSS). Actions to diversify economic activity are aimed at the agriculture, livestock, fishery and forestry sectors. In that context, a study on the development strategy in the cotton subsector is under way. At this juncture, privatization focuses mainly on agroprocessing units and hotels. In addition, the authorities intend to transfer to private operators the fire, accident and miscellaneous risks portfolio of the liquidated insurance company (SONAR).

To encourage private sector developments, the authorities are working with the World Bank on a plan to streamline regulations, modernize business laws, and create a more efficient judiciary system. In addition, the adoption of a new investment code is expected before the end of this year.

On the external sector, policies contemplated for 1996–97 are designed to narrow the external current account deficit, excluding official grants, from 8.6 percent of GDP in 1995 to 7.4 percent in 1996 and 6.5 percent in 1997. My authorities are actively supporting the regional integration efforts within WAEMU. Starting in July of this year, member countries have introduced preferential treatment for intra-community trade. Benin also supports the efforts under way to adopt a common external tariff structure. Since June of this year, Benin has agreed with the acceptance by WAEMU member countries of the obligations of Article VIII, Sections 2, 3 and 4, of the Fund's Articles of Agreement.

As indicated in the staff report, Benin's external debt is heavy. My authorities are strongly committed to the implementation of strong fiscal and structural measures, hoping that with adequate external support, Benin will be able to progressively reduce its external debt burden and achieve external viability over a foreseeable future.

On statistical issues, it is important to stress the fact that efforts are being made by my authorities to improve the quality, the coverage and the timeliness of Benin's economic and financial data in order to facilitate the monitoring of movements in relevant macroeconomic aggregates. They would also like to indicate that they remain ready to take additional measures that may be required in order to preserve the main objectives of the program.

In conclusion, my authorities would like to reiterate their strong commitment to the adjustment process. However, it should be noted that the success of their ongoing efforts will depend on further availability of external financial resources on concessional terms, including debt rescheduling. In that context, my authorities hope that they will be able to obtain debt relief from the Paris Club at least on Naples Terms. They look forward to continued close collaboration with the Fund staff.

Mr. Loevinger made the following statement:

As noted in the very helpful appendix of the staff report, Benin has made considerable progress under a succession of Fund programs. It is certainly encouraging to see Benin become one of an increasing number of African countries who are reaping significant benefits after adhering to stabilization policies. The staff deserves a lot of credit as well.

Rather than striving for much additional tightening of financial policies, the proposed arrangement appears to be targeted more toward consolidating the progress that has already been achieved and boosting growth in what is still one of the poorest countries in the world. In Benin's case, this strategy largely makes sense. In fact, this program is a good example why one shouldn't automatically put the word "austerity" between the words "the Fund" and "program."

To achieve the targeted growth rate, the program calls for an increase in investment. To maintain a viable external position, the program correctly targets an increase in domestic savings. However, the government's contribution to this increase in savings is limited. Public savings as a percentage of GDP would remain unchanged between 1995 and 1998. All of the 3 percentage point of GDP increase in domestic savings during this time would come from the private sector. If the increase in private savings fails to materialize—and we know it is very difficult to predict private savings behavior—then both the medium-term growth and current account targets could be threatened.

We thus wonder whether it wouldn't be more prudent to strive for a slightly larger fiscal consolidation. This might even allow Benin to close the residual financing gaps for the remaining years of the program. An additional fiscal effort might also allow this ESAF, after many years of Fund support, to be an exit program. Given that government revenues are projected to remain under 15 percent of GDP, and the need to boost spending in priority sectors, we urge the authorities to consider increasing revenues further. Staff comments would be welcome.

While we agree with the staff on the need to maintain public investment at a high level, the quality of such investment is as important as the quantity. Ensuring that investment funds are well spent will also help secure external assistance. We were thus concerned to see that the authorities cut spending on health and education to increase investment for the summit of francophone countries. It hard to see how building new hotels for senior government officials advances the authorities' objective that the benefits of growth be widely dispersed.

The authorities could partly offset the contractionary effect of additional fiscal consolidation by accelerating structural reforms. The new strategy the authorities are preparing on the cotton sector is a good opportunity to ensure that producers receive adequate incentives. While the authorities have allowed private firms to become ginners, it appears that limits on producer prices mean that they, rather than the cotton producers receive most of the profits. We thus urge the authorities to consider ways to liberalize producer prices. With the entry of private ginners, the authorities should also privatize SONAPRA (the government-owned ginner). In addition, while the authorities should be commended for removing price controls on several products imposed after the devaluation, it is difficult to see the justification for continued controls on petroleum products and cement.

Finally, I have a few points on external assistance. First, while Mr. Koissy focuses on the need for additional debt relief from the Paris Club, almost as much debt is owed to non–Paris Club creditors. We urge those creditors who have not yet reached an agreement to provide debt relief on terms similar to those provided by the Paris Club.

Second, the staff report notes that Benin exceeded the unadjusted end-December benchmarks for central bank net domestic assets and net bank credit to the government by CFAF 16 billion, due to a shortfall of this amount in external assistance. Because the limit for adjusting these targets was CFAF 12 billion, the targets were missed. Under the proposed program, the maximum allowable adjustment for these targets due to shortfalls in assistance would be increased to CFAF 20 billion, about 1.8 percent of GDP. This seems large. It would be useful if the staff could comment on how this ceiling compares to other arrangements. Are there general guidelines for such adjustments?

Finally, while the staff report notes that there were delays in disbursing the first tranche of the World Bank's SAC III loan, there was no discussion of this in the appendix on World Bank relations. As this chair has stated in the past, it would be useful if these appendices were more candid about countries' track record in implementing Bank programs.

Mr. Fontaine made the following statement:

I very much welcome that Benin's newly elected authorities have confirmed their commitment to economic reforms. Benin's structural adjustment program, since the late 1980s, strengthened by the CFA devaluation in January 1994, has brought about a strong improvement in the country's economic performance.

Although prospects for sustainable growth have considerably improved, the economic prospect remains fragile, as a result, among other factors, of an undiversified agricultural sector, a limited formal private sector development and a vulnerability to developments in neighboring Nigeria.

The proposed program clearly addresses these challenges. I would like, first, to make two general remarks:

Benin's achievements under previous programs, in particular before the devaluation of the CFA franc, allowed Benin to adopt perhaps less rigorous policies than in other CFA countries, in particular concerning the fiscal and the wage policies. government investments and social outlays have indeed expanded rapidly. Civil service salaries have increased markedly, following the devaluation of the CFA franc, but this did not preclude a steady decline in the wage bill in relation to GDP, to 5.2 percent in 1995 and a remarkable reduction in inflation to the low pre-devaluation level. However, the overall fiscal deficit—on a commitment basis and excluding grants—and the current account deficits have widened during the last period. It is welcome that, notwithstanding the expected substantial external aid to be received in 1996 and 1997, the authorities have decided to reduce further domestic and external imbalances, with a view to eliminating Benin's dependence on exceptional external assistance over the medium term.

The proposed program also addresses the authorities' concerns that growth could also benefit the poor and allow for an improvement in basic social services. Staff discussions have been very useful to avoid any misunderstanding on this issue.

The proposed program requires a strong determination to reinforce the favorable fiscal position achieved in recent years. The cotton sector contribution to the budget have become very significative since the devaluation, and the rise in world cotton prices. Together with the tax reforms implemented during 1989–95, the taxation of the cotton sector has been instrumental for raising government revenue to 14.5 percent of GDP. The recent decision to reduce sharply the level of taxation of cotton, beyond the level expected by Fund and bank staff, requires that offsetting revenue enhancing measures be implemented with determination. Especially as these sometimes difficult measures should intervene at the very moment when the current system of automatic advancement in the civil service will be revised. I welcome that the authorities had confirmed this decision. Somewhat surprising is the ambitious recruitment program in the education sector. Its impact on the wage bill will be significant. I concur that the status of education in Benin compares unfavorably with other low-income countries. I wonder, however, whether a more progressive approach would not have been more appropriate, in view of past difficulties at containing the wage bill within the program limit, and given the risk that newly recruited "contractual staff" may strive toward integrating the regular civil service. Improvement of literacy and school enrolment is also to be accompanied by improvement in the quality of education services. I look forward to the round table with donors which will discuss the authorities' education strategy in detail.

The cotton output has increased in a spectacular manner in recent years as a result of the integrated organization of the sector. While reviewing the price-setting mechanisms in the cotton sector and the role of the new private ginneries—a structural benchmark under the program—the authorities will have both to encourage further private sector participation, since the increase in the seed production requires additional investments, and to retain this successfully integrated organization. The recent study, completed with the World Bank assistance, provides useful proposals that the authorities should rapidly consider to avoid prolonging the climate of uncertainty among private investors.

Besides the spectacular result of the cotton sector, little progress have been made in diversifying the country's export base. It is welcome that the Bank will provide support to a private sector promotion program. It will be worthwhile assessing the reasons why Benin's financial sector continues to exhibit such prudence in their lending decision, while lending rates have showed this stickiness to the reduction in interest rates in the money market. Staff comments would be welcome.

Following several years of successful adjustment, Benin is a candidate for a stock-of-debt reduction. I would like to make two remarks.

I agree with the staff that debt sustainability in Benin—as in other CFA countries—should be primarily viewed in terms of the sustainability of the fiscal position and, from this perspective, the debt burden remains relatively large, nearly 19 percent of fiscal revenue until 2000.

Furthermore, the capacity to service the debt can be severely constrained by external shocks, including a sharper than expected decline in cotton world prices or adverse developments in the reexport trade to Nigeria. The background paper shows clearly the instability of these revenues in recent years.

Mr. Mafararikwa made the following statement:

Both Mr. Koissy's preliminary statement and the staff report leave no doubt as to the commitment of the authorities of Benin to the restructuring of the economy and the pursuit of sound macroeconomic policies. This commitment is beginning to show fruitful returns in the form of strong growth and low inflation. I support the basic thrust of the economic program, and I believe that Fund support through the ESAF would play a strong catalytic role in helping the authorities to mobilize the financial assistance that is needed to keep the reform effort on course.

Given the widespread poverty in Benin, I welcome the fact that the authorities are placing more emphasis on the expansion of education and health services in the generation of employment opportunities. This effort deserves the support of the international community.

I note that the program aims to promote diversification. However, there is not much in the report on how this is to be achieved. Our attention has been drawn to the fact that Benin has been implementing programs within the framework of the SAF and the ESAF since 1989, and yet the basic structure of the economy has not changed much. The prospects for growth in 1996 and 1997 have been defined largely in terms of developments relating to the cotton crop. This leaves the economy in a highly vulnerable position.

The medium-term program seems to assume a strong investment effort. However, the average investment ratio projected for 1997–99 of about 19.3 percent of GDP is not much different from the investment performance of 1995, which was about 19 percent. While on the investment issue, perhaps the staff could comment on the prospects for direct foreign investment.

Finally, on the debt issue, Benin will need substantial debt relief. Given the track record of the authorities, I hope that the creditors will respond accordingly. I wish the authorities well in their endeavors.

Mr. He made the following statement:

The Beninese authorities should be commended for the continued success in program implementation and, in particular, the satisfactory economic performance as evidenced by sustained strong growth, a sharp reduction in inflation and the further improvement in public finances. Indeed, challenges, as described in the policy framework paper, remain formidable. A successor ESAF arrangement would just serve to reinforce the authorities' efforts to address them. I agree with the thrust of the staff appraisal and the key elements of the proposed program and would like to make a few comments.

With regard to the medium-term program, the strategy is well focused and the objectives appropriate. The first year targets for growth, inflation, and the external current account deficit reduction appear realistic. However, it would be appreciated if the staff could provide some more information on the latest production and trade developments. For example, what caused the 40 percent increase in customs receipts in the first quarter? An unlikely import surge might have been inconsistent with the program expectation of a 3.5 percent increase for 1996. Did the trend continue in the second quarter?

Prudent fiscal policy remains essential to reducing reliance on external assistance. We welcome expenditure restraint measures, in particular, concerning the wage policy. We also welcome efforts to secure compensatory revenue increases to offset the expected reduction in tax receipts from the cotton sector as well as measures aimed at improved expenditure composition in favor of priority areas including health, education and infrastructure development. It is encouraging to note that these elements have been incorporated in the program.

In the financial sector, the significant increase in deposits with commercial banks and nonbank financial institutions reflected financial deepening and enlarged domestic sources for financing private investment. The authorities' support for a deepening of the regional financial and monetary market will prove rewarding over time.

On the structural front, efforts should focus on full exploitation of the potential of the cotton sector, invigorating private sector activity and promoting the diversification of economic activity and exports. The cotton sector currently accounts for about 20 percent of GDP and 50 percent of exports, which highlights the vulnerability of Benin's external sector and the entire economy to exogenous shocks. An effective solution would be to increase the currently very low level of value added to cotton related activities.

> This would require further opening of the sector to private, including foreign, investment, which could not only introduce production technology and management expertise, but also expand marketing channels and improve the skills of the local labor force. Although a few private cotton ginning plants have been allowed to operate, private involvement in cotton related processing is still limited. In this regard we welcome the study of the development strategy in the cotton sector. Staff elaboration on the findings of the study will be appreciated. Benin will have much to gain from encouraging private investment in cotton processing as well as in the entire manufacturing sector, which accounts for only 8 percent of GDP. A strong manufacturing sector would promote economic diversification and labor skills. This will occur once the efforts in infrastructure development are complemented by progress in cultivating for the private sector a favorable institutional environment characterized by an efficient public administration and a sound judiciary system.
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> Finally, the authorities' diligent efforts deserve strong external support, and I strongly support the proposed decision.

The staff representative from the African Department remarked that the authorities could increase revenues a number of ways, but that the revenue/GDP ratio would not increase significantly, particularly because the revenue contribution of the cotton sector was expected to decline. Moreover, the economy was largely agriculturally based, and agriculture was not substantially taxed. Some revenue growth could come from customs duties on merchandise trade landed in Benin harbors and headed for Nigeria; customs controls had been improved and revenues in the first half of 1996 had been relatively buoyant. Also, the value-added tax remained an important source of revenue and it was relatively well-managed—thanks, in part, to Fund technical assistance. Over the medium term, considering the authorities' desire to reduce the cotton sector's tax burden, more effort in other sectors would be needed; the staff had recommended that the authorities consider imposing indirect taxes on such sectors as cement and petroleum.

The ambitiousness of fiscal adjustment depended, in general, on the achievement of stronger revenue performance, the staff representative continued. However, expenditure in the social sector, especially in education and health, had lagged behind other types of expenditure over the previous few years. Given that the overall situation of public finances was relatively strong, the staff supported the increased spending in the social sector.

Shortfalls in external assistance, the staff representative explained, should be offset by the government first by limiting expenditures and boosting revenues, and then by relying on bank credit. The contingency measures for 1996 had been increased over those for 1995, partly because the exact timing of substantial bilateral aid disbursements was not clear. The staff would continue to monitor the data on monthly credit to the government from the central bank, as well as the flow of external assistance, in order to design better any adjustments to the program performance criteria, and to ensure that any shortfalls were associated with a delay, rather than with a sustained shortfall in foreign financing.

The staff representative from the Policy Development and Review Department added that adjustments in program performance criteria, as a general practice, had been designed to accommodate uncertainties in foreign financing. For example, if foreign financing surpassed expectations, then downward revisions would be made to the criteria for net credit to government and net domestic assets, because, in principle, financing should not substitute for economic adjustment. Similarly, a shortfall in foreign financing would trigger some limited relaxation of the net credit to government and net domestic assets ceilings; however, the loss of foreign financing would also have to involve some domestic economic adjustment. The staff monitored such situations carefully and on a case-by-case basis to ensure that programs remained on track.

The staff representative from the African Department noted that banks in Benin continued to be reluctant to increase lending owing to the historically difficult experiences they had faced. In particular, the entire banking system of Benin had experienced a major crisis in 1988, with the three government-owned banks essentially going bankrupt. The new private sector banks that had entered the market remained prudent, concentrating on financing international trade and secure domestic projects. As a result, there had been much emphasis placed by the authorities on strengthening the rural cooperative savings and credit institutions. Such institutions had developed well in Benin—to the point where they were currently considered as a model for the region. The cooperatives were based on the savings of farmers, and might be better attuned than larger banks to finance small-scale projects, especially in rural areas. The challenge of strengthening and deepening financial intermediation in Benin and in other countries of the region remained, and the World Bank was providing significant assistance to strengthen the network of cooperatives.

A major challenge facing a country like Benin was attracting foreign investment, the staff representative stated. Much of the recent investment had been concentrated in the cotton sector. The authorities, in consultation with the World Bank, were considering measures to increase and diversify investment opportunities, including the establishment of a free trade zone, improving technical and vocational training, and streamlining the regulatory framework that might currently be hampering foreign investment.

Increasing value-added and processing in the cotton sector was important, in part because it would also increase employment, the staff representative said. While there was some processing by several relatively small-scale companies, more investment, including foreign investment, was needed to realize the potential of the sector. A recent study by the World Bank and financed by the major donor countries had concluded that the current system—in which both the private sector and public sector ginners operated—should be continued, albeit with some modifications, such as increased flexibility in producer prices.

However, given that production in the sector had risen substantially since 1990, there was some reluctance to alter a system that was working well. Nevertheless, the government and the donor countries were reviewing the recommendations of the study, and the government had signaled that it was considering the modalities of the privatization of SONAPRA, the government-controlled marketing and ginning company.

Mr. Guennewich made the following statement:

After reading the staff's positive assessment of the overall successful performance since 1989, I was surprised by Benin's renewed request for a Fund arrangement. If the results of the adjustment programs had been really encouraging, as observed by the staff, one would have expected that Benin had achieved a sustainable external position and, thus, no longer relied on the Fund's financial assistance. In this context, it is also noteworthy that, after the expiration of the three-year ESAF arrangement to be approved today, the period of almost uninterrupted Fund support to Benin will amount to ten years, which, in our view, raises the question whether in the case of Benin the condition of the temporary use of Fund resources is still met. I hope that the staff's expectation regarding the attainment of a sustainable balance of payments position by the end of this program will materialize. After a prolonged use of Fund resources, a break in Fund financial support will be called for not only with regard to the temporary character of Fund support but also with regard to the scarceness of ESAF resources.

On the strength of fiscal adjustment, I can associate myself with Mr. Loevinger's remarks, so I can turn to the role of the government sector in the cotton sector. It is unsatisfactory that, after several Fund arrangements, the important cotton sector is still largely controlled by the government. The prevailing system of price fixing, stabilization, and redistribution of profits somewhat resembles resource management in a centrally-planned economy. We regret that even under the new ESAF-supported program, whose main focus is on the removal of the persistent structural rigidities, no major reforms are envisaged in the cotton sector. The study undertaken by the World Bank to reform the cotton sector seems to aim more at the preservation of the interventionist structure than on enhancing resource allocation. We believe that structural reforms in the cotton sector should concentrate on considerably reducing the government's role through a policy of deregulation and, in particular, comprehensive privatization. In this context, we do not understand the staff's reservation about privatization in the cotton sector, which, according to the staff, would involve social and political dimensions that need to be considered. Could the staff comment on whether this means that a continuation of the present management of the cotton sector would be preferable to a more marked-based approach?

Mr. Santos made the following statement:

Benin's economic and financial situation has improved substantially since the launching of its adjustment program in 1989, which involved a major reorientation of economic policies focusing on a reduction in the size and role of the public sector, the establishment of an environment more favorable to private sector activity, and an improvement in public finances. Performance under the 1995 ESAF-supported program was again satisfactory, as the country benefited from a significant improvement in its terms of trade and from the increased competitiveness that resulted from the devaluation of the CFA franc in 1994. GDP growth increased to almost 5 percent, public finances have continued to improve, and inflation has converged rapidly to pre-devaluation levels, even in a context of price liberalization. In this regard, we welcome steps taken in dismantling price controls and would encourage the authorities to make further progress toward full price liberalization.

As for the program, we would have welcomed a slightly more ambitious effort to reduce the overall fiscal deficit over the program period than that proposed by the staff. A stronger adjustment would go a long way toward closing the remaining financing gap for 1997, thus eliminating the need to mobilize additional external aid and/or to ask Paris Club creditors to include debt previously rescheduled under London terms in the stock of debt eligible for rescheduling under Naples terms.

Concerning monetary policy, we welcome the WAEMU authorities' intention to develop indirect instruments of monetary control to strengthen the ability to influence interest rates and contribute to the development of financial markets in the zone.

Finally, we were struck by the high degree of sensitivity of the economic outlook to the assumptions made for GDP growth, which basically depends on the expansion of cotton exports and on changes in terms of trade. This underscores the importance of making additional progress in diversifying the economy and strengthening the export base through a dynamic private sector and sustained investment effort.

Mr. Tahara made the following statement:

Under the previous program, the authorities made significant achievements, including reducing inflation, enhancing economic growth, and improving the fiscal and external balances. I commend their efforts.

Many challenges remain to be tackled, however. Among these, diversification of the economy, the promotion of private sector activities, and the maintenance of sound macroeconomic policy, are the most important. In addition, the external situation remains fragile.

Since I broadly share the staff's assessment of the economic situation and the contents of the program, I will just comment on two points for emphasis.

At the previous Board meeting on Benin, I recall that many Directors pointed out the necessity to reform the automatic promotion system in the public sector in order to limit wage expenditure. In this respect, making the reform a performance criterion is appropriate. Containment of the public sector wage bill is crucial for improving the fiscal balance. It also creates room for increasing expenditure on the social sector and public investment. I hope the reform will be implemented without delay.

Under this program, further efforts should be made to diversify the economy, in particular through promoting private sector activities. In this respect, a concrete action plan to encourage private sector development, including a plan to establish a legal and regulatory framework favorable to the private sector should be adopted and implemented as soon as possible.

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

Mr. Hamilius made the following statement:

Though one of the poorest nations in Africa, Benin has steadily been improving its macroeconomic performance under an ESAF-supported adjustment program. The figures for growth, inflation and public finances given and the liberalization measures enumerated in the staff report reflect the good progress made in recent years. Benin therefore deserves our support and we are glad to support the proposed decision.

However, commendable as these achievements are, vigorous effort will still be required to make Benin capable of the sustained growth that alone can alleviate the endemic poverty. Since I broadly agree with the staff's appraisal, I have only a few comments on fiscal policy and the debt situation.

Benin has made remarkable efforts on the revenue side, and revenue collection has become impressive, reaching 14.8 percent of GDP. It is nevertheless still clear that the present economic environment could generate additional revenues, and strengthening the administration of customs will certainly help achieve this goal.

But I am much more concerned by the expenditure side. In fact, a number of disturbing elements have somewhat blurred the fiscal picture. Wage restraint will be the key to continued success, and like other speakers I find the wage bill overruns worrisome. In addition, housing allowances have been granted to all civil servants, imposing an unnecessary burden on the budget. The staff is correct that wage increases should be more closely tied to merit and performance. The system of quasi-indexed wages and automatic promotions also needs to be revised. We also regret that the amounts allocated for health and education expenditures are lower than had been agreed with donors. I sincerely hope the Beninese authorities will find some way of funding these vital sectors adequately . In addition, the authorities have to streamline their budget process to ensure that budgetary appropriations are actually spent.

The analysis of Benin's debt sustainability reveals no unmanageable problems in prospect, provided that Benin stays on the current adjustment path and continues to receive donor assistance. It is clear that Benin fully deserves external support, which has been supporting strong, well-implemented adjustment efforts in recent years.

In conclusion, let me wish the authorities continued success in their adjustment efforts.

Ms. Brownlee made the following statement:

I would like to make two brief comments to add support to my colleagues' earlier points. We understand that Benin's foreign reserves are now at a comfortable level, and the access level has been accordingly reduced to 60 percent of quota. Given the current reserves position, we might have been tempted to reduce the access level further. This would have left a viable level of monitoring and support in place, and would have fulfilled Paris Club conditionality; it would have also ensured an optimal use of scarce ESAF resources and reduce the buildup of Benin's debt in later years. We hope that the staff will keep this under review.

We were grateful for the staff's debt sustainability analysis. While it shows that the manageability of Benin's debt is more assured than that of a good number of possible Heavily Indebted Poor Countries (HIPCs), the burden of external debt servicing will remain substantial for some time. In addition to Benin's continued adherence to the economic reform agenda, we hope that the staff assumption of the full implementation of Naples terms will be met soon by the Paris Club.

The staff representative from the African Department remarked that comprehensive privatization of the cotton sector would be complicated by certain issues. First, replacing the government monopoly with a few private operators would create an oligopolistic situation in which significant rents would accrue, given the difference between the producer prices and international prices. Second, the current government-owned agency provided various benefits—including road construction and the provision of credit to farmers—that private firms might not provide. The provision of credit to farmers, for example, was essential for the purchase of fertilizer; in Benin, as in other western African countries, strong networks of rural credit banks did not exist.

Mr. Guennewich considered that the dominant role of the government in the cotton sector was part of the problem, not the solution, facing the sector. The Fund had been clear in its policy advice to economies in transition: the government should have a reduced role in the economy; the Fund should be equally clear in its policy advice to countries in western Africa.

Mr. Loevinger said that he agreed with Mr. Guennewich that, although it had a role to play in the development of the country's infrastructure, the government should not be so dominant in the marketing, buying, and selling of cotton in Benin.

The staff representative from the African Department stated that the current system had been working well, with the production of cotton increasing significantly. That said, it was true that the government should gradually reduce its role in the cotton sector; in fact, the government was planning to withdraw from the sector by granting the farmers, grouped together in cooperatives, an increasingly important role.

The staff representative from the World Bank stated that, ideally, the cotton sector in Benin should be liberalized fully. However, there were two important constraints to the achievement of that goal. First, as the Fund staff representative had pointed out, there was a problem regarding the mechanism for the delivery of inputs and particularly the provision of credit to finance those inputs. The current system in Benin was working satisfactorily: cotton production had improved considerably, producer prices were the highest in the region, and the sector had made an important contribution to the government's fiscal program. As a result, care must be taken not to harm what had been working well, while recognizing that some evolution was necessary. Second, it must be recognized that Benin was departing on its reform of the cotton sector from a position in which the current system was performing well. As a result, the recent World Bank study proposed a three-year program that would involve the privatization of the government-owned company and new arrangements grouping all of the ginning companies for the purchase of seed cotton in order to assure a proper credit recovery mechanism. That program would not entail full liberalization, but it would represent an important step in that direction; indeed, if the government proceeded with those recommendations, it would continue to lead the west African region in progress in the cotton sector.

Mr. Fontaine said that he agreed with the staff representatives from the African Department and the World Bank: it was important not to destroy a system that was working well.

Mr. Koissy made the following statement:

> On behalf of my Beninese authorities, I would like to thank my colleagues for their comments and the support they have expressed for Benin's adjustment efforts. Their recommendations regarding Benin's future policy actions will be conveyed in full to my authorities.
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> I noted the interest expressed by some Directors with respect to the future role of the government in the economy. Let me say that Benin has been through a process of political and economic transformation since 1989, and progress has been achieved on both fronts. Politically, Benin has gone from a one-party to a multi-party system. This transformation has made macroeconomic management more transparent, and adjustment efforts are now supported by a large consensus in the country. This development is positive because it makes the commitment of the authorities more credible.
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> Economically, Benin has abandoned its central planning for a market-based system. In this vein, the ongoing restructuring efforts are assigning a more important role to private sector activity. While the authorities have taken a gradual approach in their reform actions, they are determined to pursue them and to limit the involvement of the government to activities where the private sector cannot be more effective. In that context, a number of state-owned enterprises will be privatized, and the remaining enterprises will be restructured or liquidated. government efforts are also aimed at strengthening the functioning of the banking sector, because the authorities understand the importance of a sound banking system to the improvement in the overall macroeconomic performance.
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> Regarding the implementation of financial and structural measures, I would like to reaffirm my Beninese authorities' willingness to consider the introduction of additional measures if the achievement of the objectives of the proposed program were jeopardized. However, it should be stressed that the success of their various policy actions will also depend on the availability of external financial resources on concessional terms. In that context, my authorities hope that they will continue to enjoy the support of the international community.

As indicated in my preliminary statement, Benin is a heavily indebted low income country. Its stock of external debt was equivalent to 82 percent of GDP at the end of 1995, and debt service represented about one-third of government revenue. Benin's debt position is considered sustainable; however, it should be emphasized that its sustainability depends on a favorable international economic environment and a continued strengthening in the fiscal position. Consequently, my authorities would like to reiterate their commitment to the implementation of strong fiscal and structural measures during the period ahead. They hope that their country will benefit from generous terms of debt relief from Paris Club creditors and other creditors in order to reduce progressively their external debt service burden over a reasonable time frame.

On statistical issues, my authorities recognize that their country's statistical base remains weak and are making efforts to improve the quality, the coverage, and the timeliness of economic data. The central bank and the Statistical Institute are making additional efforts in this area. Finally, my authorities would like to thank the staff for its policy advice, and look forward to further close collaboration with the Fund.

The Acting Chairman made the following summing up:

Executive Directors were in agreement with the thrust of the staff appraisal. They noted the considerable improvement in macroeconomic performance in Benin in recent years, with robust growth and lower inflation, following the implementation of successive adjustment programs. However, Directors noted that the economy remained insufficiently diversified, and that policies needed to be strengthened to increase national savings, attract foreign direct investment, and support private sector activities.

Directors called for a stronger fiscal effort to reduce reliance on foreign resources and to contribute to raising domestic savings. At the same time, they stressed the need for raising the share of budgetary resources allocated to the education, health, and other social sectors through containment of the wage bill and civil service reform. In addition, they urged the authorities to continue their efforts to enlarge the government revenue base, maintain a prudent wage and recruitment policy, select capital projects carefully, and prioritize expenditures. While Directors welcomed the decision to reduce the burden of taxation on the cotton sector through higher producer prices, they called for offsetting revenue measures.

Directors stressed the need for a growing role of the private sector. They encouraged the authorities to pursue with determination the privatization program to help foster private sector-led growth. In particular, it was recommended that the role of the government in the important cotton sector be reduced, but the substantial increase in cotton production in recent years was also noted.

Directors welcomed the broadening of financial instruments that was under way, the creation of a regional financial market, and the deepening of the regional interbank market, as means of promoting a more efficient allocation of financial resources in the region.

Directors were of the view that Benin's adjustment efforts deserved continued support from the international financial community. Viewed from the standpoint of fiscal sustainability, Benin's external debt was high. However, following the debt stock reduction operations requested by the authorities, external debt indicators should improve in the coming years. Nevertheless, the economy remained highly vulnerable to exogenous shocks. Accordingly, a rigorous implementation of sound macroeconomic policies and structural reforms was essential, combined with a prudent debt management policy and adequate financing on concessional terms, to achieve broad-based growth and external debt sustainability over time.

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

The Executive Board took the following decision:

1. The government of Benin has requested a three-year arrangement under the Enhanced Structural Adjustment Facility, and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for Benin set forth in EBD/96/105.

3. The Fund approves the arrangements set forth in EBS/96/127, Supplement 1.

Decision No. 11329-(96/80), adopted
August 28, 1996

3. SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya (SM/96/175, 7/11/96; Cor. 1, 7/26/96; and Cor. 2, 8/27/96). They also had before them a statistical annex (SM/96/197, 7/29/96).

Mr. Shaalan made the following statement:

The external environment facing Libya continues to affect and shape the country's economy and economic policies. The UN sanctions imposed since 1992 continue to impact the economy adversely, further inducing shortages of inputs and spare parts and seriously undermining the growth of production capacity and productivity, in addition to increasing the cost of imports. These sanctions have extended and exacerbated a situation already made difficult by the sanctions imposed by the U.S. government since 1986, which include the freezing of Libya's accounts in the United States or with U.S. banks and the prohibition of the exportation of equipment and other material related to the petrochemicals industry. As these measures coincided with weakening international oil prices and sharply declining oil revenues, the impact on output was substantial. More recently, these developments have been tempered by the authorities' adjustment policies aimed at addressing some of the challenges posed by the adverse developments in the external environment. The recent upturn in oil prices in 1995 also ameliorated the situation. Over the period 1994–95, financial policies have been tightened, the official exchange rate depreciated, and the process of enhancing the role of the private sector in the economy continued. As a result, inflationary pressures abated during the period, and the fall in GDP was limited to an annual rate of about 1 percent, with non-oil output falling at a slightly higher rate. The outlook for 1996 is more favorable, with a projected 2 percent growth in GDP—2.6 percent for non-oil output—and a further decline in inflation.

Since the last Article IV consultation in 1994, the Libyan authorities have focused their fiscal policy on containing expenditures and on enhancing non-oil revenues. Their efforts, supported by the increase in oil revenues in 1995, have resulted in a significant improvement in the overall fiscal position which turned into near balance, compared to a deficit of some 3 percent of GDP in the previous two years.

The enhanced fiscal revenue performance was mainly due to a sustained increase in non-oil tax revenues following improved tax administration and collection. On the expenditure side, the burden of adjustment in 1994 fell mostly on development expenditures which were cut back somewhat. In 1995, and notwithstanding the increase in oil revenues, the authorities continued to restrain the growth in wages and increased development outlays while maintaining the growth in total expenditure within the increase in oil revenues. The current year, 1996, is projected to witness a further sharp increase in non-oil revenue, reflecting the authorities' stepped up efforts at enhancing revenue mobilization. This has permitted the accommodation of a substantial rise in development expenditures while maintaining a near balanced budget. For the future, the authorities intend to continue with the improvements in tax collection and administration while introducing improvements in budgetary control. They have also advised the staff of their intention to work more closely with them on tax and exchange rate reforms.

Monetary policy in Libya continues to be geared to the provision of low cost financing to priority activities. The Libyan authorities recognize the need to liberalize monetary and exchange rate policies. However, their drive for opening up and reducing controls is much constrained by the existence of sanctions. This notwithstanding, and in line with the authorities' strategy of diversifying the economy's productive base by promoting a more dynamic role by the private sector, several private banks have been licensed recently.

On the external front, in view of the uncertainties caused by the sanctions, imports have been significantly reduced since 1994, partly by direct controls but also as a result of the tightened financial policies. The contraction in imports contributed to a substantial improvement in both the current and overall external balances, which are now in surplus, while gross official reserves reached a comfortable level which is equivalent to about 11 months of imports, compared to a little more than 6 months in 1994. Moreover, the exchange rate in the parallel market has been relatively stable since 1993.

Libya's economic strategy is to expand its oil and gas productive capacity, and to continue to promote the diversification of economic activity through the promotion of private sector participation in virtually all lines of economic activity. The authorities remain committed to these goals and, through various measures and initiatives, have succeeded in expanding the role of the private sector across a wide range of activities, including manufacturing, banking, education, health and other services. Clearly, the imposed constraints on links with the rest of the world and the effects of the sanctions and the threat of their intensification have seriously constrained private sector activity and the overall potential and performance of the economy. Moreover, while the authorities recognize the need for setting a medium-term framework for formulating macroeconomic policies, the external environment renders carrying out this task difficult.

The Libyan authorities are mindful of deficiencies in their data base, and they have already submitted a request for a multi-sector statistical mission which they hope can take place in the near future.

Mr. Daïri made the following statement:

First, let me commend the staff for a concise and well-written paper and for their clear presentation of the issues facing Libya. Overall economic developments in Libya during recent years have been adversely affected by an extremely difficult external environment and falling oil prices. The high reliance of the economy on oil exports and revenue makes the country vulnerable to international oil price movements. Moreover, the Libyan economy suffered extensively from unfavorable weather conditions, as well as the UN sanctions that affected almost all sectors of economic activity, and, more importantly, hampered efforts toward diversification.

Nonetheless, the authorities succeeded in containing the impacts of these adverse developments on the economy. The overall budget position improved over the last three years from a deficit of 3.3 percent of GDP in 1993 to 2.7 percent in 1994, and to a small surplus of 0.3 percent of GDP in 1995. The tightening of financial policies led to a substantial decline in the external current account deficit over the years 1993–94, and to a strong surplus position of 5 percent of GDP in 1995. The expansion of broad money in 1995 reflects a significant increase in net foreign assets, as expansion of net domestic assets slowed sharply, and there are indications that inflation is tapering off. While these developments reflect the efforts made by Libya toward maintaining a stable macroeconomic environment under severe external circumstances, they are also the result of sharp cuts in imports and development expenditures that hindered economic activities. Therefore, Libya's situation remains precarious, and serious challenges still lie ahead.

For many years, the Libyan economy has suffered from the lack of a comprehensive and fully integrated macroeconomic framework. Together with measures aimed at improving the regulatory environment and removing rigidities as suggested in the staff report, such a framework would provide a more favorable medium-term outlook for private sector development. This could eventually create the foundation for a more outward-oriented economy, taking advantage of the improved prospects in the region. The authorities are encouraged to work closely with the Fund for defining a coherent medium-term strategy. I would appreciate Mr. Shaalan's or the staff's comments on such a possibility.

The recent positive outlook for oil prices and the authorities' renewed intention to adhere to fiscal consolidation will improve the budgetary prospects. However, the fiscal situation remains fragile, and the authorities should adopt some revenue enhancing and expenditure cutting measures to achieve a more sustainable fiscal position. On the revenue side, given the progress achieved in tax administration and collection, it is now appropriate to implement a comprehensive tax reform aimed at widening the tax base and introducing a general sales tax. On the expenditure side, the authorities should be encouraged to contain further increase in the wage bill, reduce subsidies, and cut down nonproductive expenditures.

The main objective of monetary policy in Libya is to provide low cost financing to priority sectors. This passive approach to monetary policy in a highly regulated environment with insignificant private sector initiative undermines the high potential of monetary policy and its important role in improving resource allocation and achieving price stability. We welcome the authorities' recent initiative in establishing private commercial and development banks. The authorities should take more courageous steps in establishing more advanced money and finance institutions, and to assure that the instruments of monetary policy are largely market-based. These initiatives, combined with prudential and regulatory framework for safe and sound operation of the banking system consistent with the goal of financial stability, will play an important role in achieving economic diversification and higher growth.

The external sector position improved in 1995, reflecting a significant decline in imports and an increase in oil exports. While prospects in the oil market are favorable, some degree of relaxation of trade and exchange restrictions is warranted. Extensive trade and foreign exchange controls and an overvalued currency give distorted signals to the economy and misallocate financial resources. We are pleased to note that the authorities agree with the staff on the need for an exchange rate adjustment as a part of a comprehensive policy package, and that they would take a decision in this respect following completion of an ongoing study.

Finally, we commend the authorities for their achievements under an extremely difficult external environment that may, at times, force them to adopt measures that lead to temporary deviation from a sound policy stance. However, we are assured by Mr. Shaalan that the authorities are fully committed to policies conducive to private sector participation and trade and exchange liberalization.

We wish the authorities every success in their endeavors.

Mr. Song made the following statement:

We are pleased to see that progressive improvements were made in the balances of fiscal and external accounts by the Libyan authorities during the past year. With the effective regularization of budgetary expenditures and aggregate demand, macroeconomic stability and economic diversification were seen, to some extent, to have improved. However, the economy has not shed its difficult situation as reflected in its heavy dependence on the oil price of the world markets and scale down in capital formation. I am in broad agreement with the staff on the main thrust of the report and would like to offer some comments for emphasis.

It is encouraging to see that the authorities are aiming for a further strengthening of the fiscal position in 1996, given the need for an increase in public investment for the completion of the public works. We believe that the wealth distribution scheme will have a positive effect on the enhancement of economic growth, based on its support for the development of small and micro-projects and for the improvement of social welfare for the low income group. In the face of the increase in budgetary expenditures, the authorities are encouraged to intensify their efforts to improve tax collection in the near future. The authorities' plans for a simplification of the tax structure and streamlining of taxation procedures are conducive to the improvement of tax administration.

Great efforts are required for strengthening financial establishments in Libya, and a medium-term development program is highly warranted for an orderly transformation of the banking system. In view of the current status of its financial sector, the reform plans should be kept consistent with the progress to be achieved in the general economic structural adjustment. In this connection, financial reform is expected to be incorporated into a comprehensive economic reform program. Given the difficult task in this process, progress could be expected in a medium term perspective. The liberalization of interest rates in the banking sector could be better realized if coupled with advances in the establishment of a market-oriented financial system. Nevertheless, monetary policy and credit expansion ought to be kept on a sustained basis in conformity with the requirements for macroeconomic stability.

The Libyan external position has been dominantly affected by world oil prices, and, more importantly at the moment, by serious external constraints. As the staff has conclusively pinpointed, unless extraordinary efforts are made to address the imbalances, not only will the external account worsen, but the domestic economy will suffer to an even more serious degree.

In light of the decline in overall real GDP, and particularly the adverse trend shown in the per capita income deterioration, we can support the authorities' development strategy to strengthen the oil production capacity and promote the role to be played by the private sector in the development of non-oil industries. In this respect, the recent measures taken by the authorities in extending private participation to banking, transportation, manufacturing, education, health and other services are steps in the right direction.

With these comments, we can support the proposed decision and I would like to wish the authorities further progress with their economic adjustment efforts.

Mr. Al-Tuwaijri made the following statement:

I agree with the staff that the significant improvement in Libya's fiscal and external accounts over the past two years is encouraging. While higher oil prices were a major factor, the authorities' efforts to contain spending and tighten import and exchange controls played an important role.

These measures along with a difficult external environment, however, exacted a high toll on economic growth and increased distortions. Indeed, real non-oil GDP declined by about 3 percent in the past two years. Therefore, the challenge facing the authorities at this stage is to reorient their policies toward reactivating and diversifying the economy while consolidating the improvement in the fiscal and external positions.

As I am in broad agreement with the staff appraisal, I will make three comments for emphasis.

First, I welcome the authorities' efforts to enhance non-oil revenues. The focus on simplifying the tax structure and strengthening tax administration is a step in the right direction. These efforts will improve the fiscal position and strengthen the revenue structure. Efforts are also needed to improve the structure of expenditures. In this regard, I agree with the staff on the importance of civil service reform.

Second, the establishment of a private commercial bank and a number of local banks is a welcome step toward enhancing the efficiency of the banking sector. Success, however, depends largely on progress in interest rate liberalization. Eliminating directed credit and privatizing state owned banks are also critical. The importance of enhanced supervision and prudential regulations at this juncture can not be overstated.

Finally, priority should be given to improve the regulatory and legal environments. The staff report contains a useful inventory of regulatory hurdles to diversification and growth. The authorities make the point that the current external environment complicates the liberalization of the process. This should not preclude, however, the elimination of export taxes, the restructuring of public enterprises, and the liberalization of the price system. Indeed, such measures along with strengthened macroeconomic policies, will greatly facilitate the unification of the exchange rate and the liberalization of the import regime.

With these remarks, I wish the authorities success in their economic management.

Mr. Akatu made the following statement:

We commend the Libyan authorities for the remarkable improvement in Libya's external position and fiscal accounts in 1994 and 1995. Both of these reflect, in no small measure, the strong actions taken to restrain spending. Inflation, which climbed sharply in 1993, is believed to have abated, and although real GDP contracted further in 1995, growth is expected to resume in 1996. We also welcome the progress made toward increasing private sector participation in the context of the country's strategy aimed at promoting the growth of the non-oil sector of the economy. Libya's efforts in this regard, however, need to be stepped up and reinforced by measures geared toward improving the regulatory environment and reducing market rigidities. We see the recent improvement in financial conditions as presenting an opportunity for significant advance in this regard.

We are in broad agreement with the thrust of the staff's appraisal and make the following remarks only for emphasis.

We note that the authorities remain committed to an economic development strategy focused on strengthening the country's oil production capacities and encouraging hydrocarbon industries, as well as the promotion of non-oil activities based on increasing reliance on the private sector. This two-pronged approach has formed the core of the effort to promote private sector initiative since 1987. In this connection, we welcome the measures taken in 1995 to licence private banks and encourage the participation of the private sector in other activities. From the staff report, it seems clear that the authorities recognize the need to strengthen this policy through the adoption of a comprehensive package of measures to improve the current regulatory environment which is far from conducive for the development of a vibrant private sector and the rapid growth of non-oil production. Nevertheless, they feel compelled by the UN sanctions to maintain tight controls and restrictions in order to protect the economy.

The costs to the economy of further delay in taking the measures necessary, however, seem considerable. As noted in the staff report, cutbacks in expenditure and imports have already had significant detrimental effects on the growth of the non-oil sector. More importantly, economic efficiency continues to be constrained by a system of extensive controls that have been strengthened in response both to the impact of economic sanctions as well as financial imbalances. In order keep the drive for economic diversification alive, the authorities should seek to enhance greater consistency and coherence in policies and significantly reinforce the measures already taken to encourage wider private sector participation in the economic process. In this regard, there seems to be significant scope, in light of the recent improvement in Libya's financial situation, for relaxing controls on prices, interest rates, trade and foreign exchange controls, and shifting to greater reliance on appropriate demand and exchange rate policies for managing domestic and external sector imbalances.

With these remarks, we wish the Libyan authorities success as they grapple with the challenges before them.

The staff representative from the Middle Eastern Department remarked that the staff would consider favorably any request from the Libyan authorities for assistance in the design of a medium-term macroeconomic framework; however, no such request had yet been received.

Mr. Shaalan remarked that, notwithstanding the difficulties caused by the United Nations sanctions, much had been achieved with respect to the formulation of a more comprehensive set of medium-term policies. The authorities recognized that more needed to be done, and they had requested technical assistance from the Fund in a number of areas, including the design of a more appropriate exchange rate system.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They noted that progress had been made in reducing the fiscal and external deficits under a difficult external environment. However, that had been achieved through heavy reliance on administrative controls, with adverse effects on growth, development of the non-oil sector, and resource allocation.

Moreover, Libya's economic situation remained fragile, owing to the economy's heavy dependence on oil and the external constraints. Therefore, they encouraged the authorities to pursue their plans to diversify the economy and move toward greater private sector involvement in the economy.

Directors believed that the authorities should rely much more on market-based instruments of economic management to achieve their adjustment and reform objectives. In that regard, an improvement in the regulatory environment was viewed as key to reducing the distortions in the economy. Furthermore, Directors underscored the need to formulate macroeconomic policies in a medium-term framework to help achieve coherence and consistency in macroeconomic management.

Directors noted the improvement in the overall fiscal situation in 1994 and 1995, which reflected higher oil revenue and cuts in development expenditure. They welcomed the authorities' intention to achieve fiscal balance in 1996. In view of the uncertainties regarding oil revenue, Directors stressed the need for lasting revenue and expenditure measures in order to achieve a sustainable improvement in the fiscal situation and to reduce the vulnerability to fluctuations in international oil prices. In that regard, they placed particular emphasis on the need to complete the ongoing preparation to reform the tax system and administration, and rationalize public sector expenditure, in particular through downsizing of the civil service and cuts in subsidies and nonproductive expenditures.

Directors stressed that the domestic financial sector should play a greater role in mobilizing savings and helping to improve resource allocation. That would require, in particular, liberalization of credit allocation procedures and interest rates, promotion of competition among financial institutions, and establishment of new private institutions. They underscored the need to pursue a more active monetary policy in the context of a clearly defined macroeconomic framework designed to reduce the rate of inflation.

Directors noted that reliance on quantitative controls and restrictions on external transactions should be reduced as part of the program to deregulate the economy, and appropriate demand management and exchange rate policies should be the principal instruments for achieving balance of payments objectives. Directors underscored the need for adjustment in the exchange rate as part of a comprehensive package of policies aimed at fostering competitiveness, economic diversification, and growth.

It is expected that the next Article IV consultation with the Socialist People's Libyan Arab Jamahiriya will be held on the 24-month cycle.

The Executive Board took the following decision:

> 1. The Fund takes this decision relating to exchange measures of the Socialist People's Libyan Arab Jamahiriya subject to Article VIII, Sections 2(a) and 3, and in concluding the 1996 Article XIV consultation with the Socialist People's Libyan Arab Jamahiriya, in light of the 1996 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).
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> 2. The Socialist People's Libyan Arab Jamahiriya continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, Section 2, except for the multiple currency practices and exchange restrictions as described in SM/96/175 that are subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund urges the authorities to liberalize the exchange system and to eliminate the exchange restrictions and the multiple currency practices as soon as possible.

Decision No. 11330-(96/80), adopted
August 28, 1996

4. BANGLADESH—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Bangladesh (SM/96/54, 3/1/96; and Sup. 1, 8/21/96). They also had before them background papers on recent economic developments in Bangladesh (SM/96/70, 3/26/96) and on selected issues in Bangladesh (SM/96/193, 7/24/96).

Mr. Sivaraman made the following statement:

> At the outset, on behalf of my authorities, I would like to compliment the staff for its deep understanding of a difficult political transition which Bangladesh experienced in the first half of 1996. The staff has played a constructive role by highlighting the areas requiring reforms. The staff assessment of economic trends in Bangladesh has been sympathetic to the situation.
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> The fiscal year 1995–96 witnessed momentous political changes in Bangladesh. The boycott of unacceptable elections in February, 1996 by major political parties culminated in the establishment of a neutral caretaker government which was authorized to carry on day-to-day administration till the fresh elections were held. The present government was elected in mid-June, 1996 through an impartial democratic process under the supervision of the

caretaker government. The culmination of this process has re-established Bangladesh's commitment to democracy.

Bangladesh economy in FY 1995–96 showed resilience despite recurrence of natural calamities and political instability. GDP growth rate for the FY 1995–96 is estimated at 4.7 percent compared to 4.4 percent in the previous year. This improvement in growth is mainly due to a recovery in agriculture following a 6 percent fall in foodgrains production in the previous year. However, growth of industrial sector fell from 8.6 percent in 1994–95 to 6 percent in 1995–96. Similarly, growth rate declined in the construction sector from 7 percent to 3.5 percent and transport sector from 5.9 percent to 4.3 percent. Agricultural production increased by 1.8 percent. In spite of widespread unrest, the original target for revenue collection was attained.

The newly elected government presented a budget within four weeks of its assumption of office. In the budget speech, the government has reaffirmed its commitment to reforms in administration and economy of Bangladesh and that there will be no withdrawal or backtracking once they are undertaken. The Privatization Board has been instructed to resume its normal operations. Negotiations have already started to put the jute-sector reforms on track. The new government fully agrees with the staff recommendation that "a political consensus to put priority on economic reforms is of crucial importance." The new government has already undertaken measures for the establishment of a government based on national consensus. It is expected that the new political environment would accelerate the process of reforms.

Though Article IV Consultation on Bangladesh was delayed owing to unfavorable political environment, the staff recommendations contained in March report were actively considered by the caretaker government in the interim period. The budget for 1995–96 was revised by the caretaker government in the light of these recommendations. The Annual Development Program (ADP) for 1995–96 was reduced by 14 percent, from Tk 12,100 crore to Tk 10,447 crore.

The new budget announced in late July accelerated the ongoing tariff reform. The maximum tariff rate has been reduced from 60 percent in FY 1994–95 to 50 percent in 1995–96 and to 45 percent in 1996–97. This compares very favorably with similar rates in other South Asian countries. In the current budget, legal provisions have been made for introducing value-added tax on retail and wholesale trade sales on a selective basis. Value-added taxes have been extended to services of shipping agents, audit and accountancy firms, consultancy and supervisory firms and leasing companies. The retail trade sales of certain luxury goods like motor vehicles, air conditioners, dish antennas have also been brought under the value-added tax. The extension of value-added tax to small producers and vendors will have to proceed gradually so as to keep compliance cost at a low level and allow the trade to gain experience in the value-added tax. Emphasis has been laid on the toning up of the revenue administration for mobilization of additional resources. In the new budget, deficit has been projected to be reduced to 5.7 percent of GDP from 6.3 percent for the FY 1995–96. The actual revenue collection and expenditures are being continuously monitored. Efforts will be made to increase aid utilization. If necessary, corrective measures including reducing the size of the Annual Development Program will be considered at the time of revising the budget in the second quarter of the current fiscal year. Specifically, the recommendations contained in IDA's current Public Expenditure Review are under the active consideration of the authorities.

The new budget lays special emphasis on the agriculture sector. Total irrigated area increased by 8.39 percent during the period 1985–86 to 1989–90, as compared with 2.86 percent during the period 1990–91 to 1994–95. Bangladesh had to import more than five million metric tons of foodgrains in the last two years. The per capita availability of foodgrains, which was 459 grams per day in 1990–91, decreased during the last five years to 432 grams. This has happened in the backdrop of shrinking public expenditure in the agriculture sector. With a view to accelerating development in the agriculture sector, the government has set apart an agricultural subsidy fund of Tk 100 crore in the ADP. This fund is proposed to be used to encourage the expansion of minor irrigation and farm machinery. However, in the short run, food security will be ensured through the public food distribution system. In the current fiscal year the target for import and domestic procurement of foodgrains has been set at 1.76 million tons. Furthermore, all restrictions on import of foodgrains by the private sector have been removed. Emphasis has also been laid in the budget on poverty alleviation and human resources development. Apart from the government programs, nongovernmental organizations have also been given adequate opportunities for participation in these sectors.

The staff report refers to inadequacy of statistics on macro aggregates in Bangladesh. A recent Fund mission (May 1996) supports the hypothesis that GDP in Bangladesh is likely to be underestimated because "a large part of the country's economic activities is not reflected in the current GDP compilation process." A project will be undertaken shortly to prepare better estimates of national accounts. Questions have also been raised regarding the methodology of computing the rate of inflation in Bangladesh. The existing inflation rate is calculated with 1973–74 as base year and on the basis of consumer price index of Dhaka city alone. Recently, a new index has been prepared with 1985–86 as base year and on the basis of consumer price index estimated separately for Dhaka; all urban; all rural areas; and the whole country. The new index is methodologically superior to the old one. However, the quality of data specifically on rural areas for the new index is not satisfactory. Consequently, the old index is still used by the government. According to the old index, inflation rate was 5.2 percent in 1994–95. It is estimated at 4.2 percent for the first eleven months of FY 1995–96. My authorities' analysis of the available data showed that inflation in 1995–96 edged up initially because of the increase in food prices. Another contributing factor to inflation was the growth of domestic credit of 27.9 percent during the year 1995–96. This was immediately brought under control by the tightening of the discount window by the central bank, increasing yields of Bangladesh Bank bills and rise in the bank rate. By the end of June 1996, growth of domestic credit has been reduced to 20.4 percent. Monetary target for the current fiscal year aims at keeping the rate of inflation below 5 percent. It will be strictly enforced by the central bank. Devaluation of the taka in the last year also contributed to higher inflation.

The staff report highlights the gradual decline in foreign exchange reserves of Bangladesh in recent months. Foreign exchange reserves now stand at about $2 billion—equivalent to about 3.5 months' import requirements. Despite political instability, exports grew at the rate of 10.5 percent in 1995–96. However, imports increased by 23.3 percent during the first nine months of FY 1995–96 mainly due to sudden spurt in food imports. Remittances of expatriate nationals during FY 1995–96 is projected at $1.2 billion compared to $1.19 billion in the previous year. A major reason for the fall in the reserves is the significant reduction in the disbursement of aid. While in FY 1994–95, total disbursement of aid was $1.74 billion, in FY 1995–96, it is estimated to be less than $1.45 billion. Over the past years, Bangladesh has moved in the direction of a market-based exchange rate system through gradual elimination of exchange control. Bangladesh has been managing her exchange rate flexibly, seeking to avoid appreciation of the taka and at the same time to maintain competitiveness of exports. In accordance with this policy, the taka's competitiveness is monitored with reference to real effective exchange rate (REER) against a trade weighted basket of currencies of the country's fifteen major trade partners. The exchange rate of the taka vis-à-vis U.S. dollar (the intervention currency) is adjusted from time to time keeping in view the movement of REER. Since July 1, 1995, eight such adjustments were made depreciating taka by about 5 percent. The new government is constantly monitoring the situation. My authorities feel that the time is not as yet ripe for a switch-over to a completely market-determined exchange rate. In order to defend a completely market-determined exchange rate, the central bank needs sufficient resources so that it can intervene effectively in the face of destabilizing speculative flows. The present level of foreign exchange reserves and the market behavior do not support a move to market based exchange rate policy. It is expected that with better utilization of aid and reduction of food imports as a result of resumption of growth in agriculture, reserve position will gradually stabilize. In the meanwhile, necessary adjustments will be made in the exchange rate on the basis of REER.

The first phase of financial sector reforms initiated in late 1989 in the context of IDA's Financial Sector Adjustment Credit, has led to freeing control over interest rates, introducing loan classification, issuing provisioning guidelines, providing technical assistance to recapitalize and strengthen the institutional capacity of the banks and strengthening central bank supervision and regulation. Steps were also taken by the government through the Jute Sector Adjustment Credit to compensate the banks for the bad loans in the jute sector. Similar measures have been taken for the textile sector. Licences for establishment of six new banks in the private sector have been issued. In order to accomplish the goal of improving the credit quality of newly sanctioned loans and advances, banks have been advised to make Lending Risk Analysis (LRA) mandatory for loans of Tk 10 million and above. A loan review cell has been established in the Bangladesh Bank to monitor and give appropriate advice to the banks regarding Lending Risk Analysis. Credit Information Bureau in Bangladesh Bank has been strengthened. It is now mandatory for the banks to consult credit information bureau for sanctioning, renewal or rescheduling of loan of Tk 5 million and above. Capital adequacy norms on the lines of international practices have been prescribed. The Boards of Directors of nationalized banks have been reconstituted. Measures have already been initiated to undertake a commercial banking reform project with the assistance of IDA and Asian Development Bank. The cornerstone of government policy is to create an environment in which the Bangladesh Bank can independently play an effective role in enforcing laws and regulations. With this end in view, necessary measures will be taken to strengthen the Bangladesh Bank both in terms of human resources as well as by a clear legal mandate.

The establishment of a stable democratic government in Bangladesh based on national consensus has opened up new opportunities for the pursuit of policies of reform. In the budget speech, the government has already declared its intentions to eliminate hidden deficits, address the weaknesses in fiscal structure, introduce firmer discipline in the state-owned enterprises, accelerate privatization; streamline administration and adopt tighter financial policies in the coming months. Based on past experience my authorities want to design future reforms in a realistic manner to put the country on a sustained growth path.

The performance of Bangladesh in the fiscal and monetary areas have to be judged in the background of its history. Bangladesh was born 25 years ago in a difficult environment. It is a country which has unique problems—as year after year they have to do battle with nature's fury some times in the form of floods some times as cyclones. On most occasions a very sizable portion of the country is affected with a large section of the people getting uprooted. government has to rise to the occasion and provide relief to the people. But in spite of these heavy odds its performance has been quite creditable which the Board, I am sure, will appreciate. A recent World Bank study on Bangladesh has summed up their achievements as follows: ". . . Since independence in 1971, Bangladesh has made a remarkable progress. It has shown great resilience in the face of exogenous shocks and natural adversity and has transformed itself from an international 'basket case' to a country which is virtually self-sufficient in food with steadily increasing standards of literacy and health . . . Real GDP growth has averaged 4 percent per year and most socioeconomic indicators have shown improvement, with notable progress in food production, balance of payments, infant mortality, water supply and educational enrolment. Bangladesh has reason to be proud and optimistic." Undoubtedly, my authorities are also aware of the deep rooted institutional problems they have to contend with in the immediate future. My authorities will give due deference to all the suggestions made in the staff report and may be given at the Board to improve its performance on all fronts.

Mr. Daïri made the following statement:

The staff report for the 1996 Article IV consultation with Bangladesh is disquieting. It is all the more so, since prior to the onset of the long period of political uncertainty and the loss of macroeconomic control, Bangladesh has been rightly praised by this chair—and indeed this Board—as an economy with sound macroeconomic credentials. It is also an economy that held the promise of breaking out of its low-growth equilibrium trap onto a higher growth and investment track. Today, the economy is greatly weakened by a series of shocks emanating from the confluence of political events, an inadequate policy response, and, as the staff report puts it, a "weakness of domestic institutions of macroeconomic management." The economic deterioration has been broad-based, affecting the fiscal, monetary, and external sectors. The incidence of poverty has increased, and low inflation, which has always been the hallmark of sound macroeconomic policy implementation in Bangladesh, has edged up. Clearly, these trends are unsustainable and call for the implementation of immediate stabilization measures in the context of a new policy framework. Delays in implementing such an adjustment program will not only risk a further erosion of an already perilous situation, but will make the eventual task of adjustment a more painful and arduous one.

We are encouraged by the broad consensus, including with the new Prime Minister, on the urgent need to restore stable macroeconomic conditions. The budget, presented on July 28, recognizes the difficult challenges that confront the authorities and makes some headway toward addressing them. While this is an important first step toward regaining macroeconomic control, there is a risk that it would prove to be insufficient. The projected decline in the budget deficit is modest and depends on measures with optimistic assumptions or uncertain impact. While monetary policy appropriately aims at supporting stabilization of the budget and a buildup of reserves, it may also prove to be insufficiently tight. Accordingly, we would urge the authorities to be prepared to take additional measures should deviations in fiscal and monetary policy implementation emerge during the year.

Putting the economy on a higher, sustainable growth path will require the implementation of a bold and comprehensive set of macroeconomic and structural reforms, including a fundamental rethinking of the government's role in the economy. The elements of this reform package are well described in the staff report, and we can support them. It is clear that without visible and sustained progress with a critical mass of structural reform aimed at overcoming impediments to private investment and raising economy-wide efficiency, Bangladesh's quest to place the economy on a path of 7–8 percent annual growth and significantly improve its social indicators will remain elusive. As domestic political conditions normalize and confidence returns, it is our hope that the authorities will be able to garner the necessary political and social consensus in favor of the adoption of a comprehensive and ambitious reform agenda which will, inter alia, address the deep-seated problems of the banking system, the trade regime, the structure of taxes, the role of the public sector, and the implementation of public investment. Here, the reforms of the public sector and privatization will present the authorities with their greatest challenge. However, the potential rewards from the successful implementation of a time-bound action plan would appear to be considerable. A renewed program of public enterprise reform and privatization, supported by the World Bank and the AsDB and designed to include a comprehensive and adequately funded social safety net, should help allay public concerns over potentially large labor displacement. As in other countries, a portion of the proceeds from privatization should be specifically earmarked for job retraining and redeployment.

On the external sector, it is not clear whether the slowdown in exports in 1995/96 represents a return to trend (following the exceptional performance in 1994/95), or emerging competitiveness difficulties. The staff may wish to elaborate on this issue. On exchange rate management, the staff supports a shift in exchange rate policy toward a more market-determined system, arguing that it would remove speculation and enhance exports and remittance receipts. While the exchange rate warrants careful watching, we agree with Mr. Sivaraman and the authorities that greater flexibility in exchange rate management at present may in fact trigger adverse market reaction and should await the implementation of tighter economic policies and a more comfortable cushion of reserves.

We are encouraged by the authorities' intention to cooperate closely with the Fund and World Bank with a view to articulate the elements of a comprehensive reform package that will help foster higher growth in an environment of financial stability. We hope that the forthcoming Annual Meetings would provide an opportunity for an intensive dialogue that eventuates in the early resumption of a Fund-supported adjustment program.

Mr. Shaalan made the following statement:

We are encouraged by the recent improvement in political environment in Bangladesh. Hopefully this would permit the authorities to adopt bolder policies, particularly in the structural area, to achieve substantially higher rates of growth and alleviate poverty. As we have pointed out during the last Board discussion, Bangladesh presents an interesting case of a country that has done most of the right things in terms of stabilization and strong external performance without eliciting, however, an appreciable rise in the growth rate of the economy or improving social indicators. Indeed, despite the relatively low inflation rate, a significant increase in the savings rate, and liberalization of trade and foreign exchange markets, investment levels remain very low—less than one-third of the average investment in the fast-growing Asian economies. Obviously, a sustained and significant increase in the investment and growth rates is essential for Bangladesh to be able to break out the circle of poverty.

The challenge for the authorities, therefore, is to create an environment that provides incentives to private sector initiative and investment. Many of the structural weaknesses that underlie the slow growth of output and macroeconomic imbalances have not yet been adequately addressed, such as the rudimentary technology in the agricultural sector, inadequate physical infrastructure, fragile and undeveloped financial systems; weak institutional capacity in public and private sectors; and the severe constraints due to poor human-resource development. In what follows, I will focus my comments first on some aspects of the needed structural reform measures and then briefly touch on the policy mix.

On the structural front, the reform of the financial sector should be accorded the highest priority lest it endangers macroeconomic stability. Moreover, the problem of nonperforming loans by banks has resulted in a major financial burden and is an obstacle to efficient financial intermediation that needs to be addressed. In addition to the persistent high lending rates, commercial banks maintain a wide spread between lending and deposit rates, with all the attendant distortions affecting investment decisions and the cost of capital. It would appear that a spread of some seven percentage points is exorbitant. I would appreciate the staff's views. The speedy resolution of the banking problems is therefore critical. In this regard, I urge the authorities to adopt capital adequacy guidelines, restrict connected lending, enhance the supervisory capacity of the central bank, and improve the efficiency and competition of the banking system through restructuring and privatization. The potential costs of resolving bad loans in Bangladesh, however, is undoubtedly very large and could frustrate the fiscal consolidation needed to raise national savings.

Closely related to the banking problems is of course the poor performance of the public sector. The public sector in Bangladesh is still large and its inefficiencies, in addition to its mounting operating losses, need to be addressed. In particular, I would urge the authorities to consider removing remaining price controls and to proceed further with the restructuring and privatization. Increased efficiency would have the multi dimensional benefits not only to the economy but to the pursuit of appropriate monetary and fiscal policies.

In the external area, while we generally support the staff's view to move toward a more liberal regime as a basis for a sustained export drive, a more careful assessment of the balance between the benefits of a further liberalization of trade against the heightened competitive pressures that a more open system will exert on a nascent private sector is, I believe, in order. While no one can question the benefits of liberalization there could be some adverse and lasting side effects in the case of a country in its very early stages of development. In this context, it should be noted that between 1989 and 1995 consumer goods imports rose by about 60 percent while imports of raw material and capital goods rose by less than 25 percent. Undisciplined economic opening is not necessarily a reliable formula for success, and there are many lessons to be learned from the successful development experience of South Korea and Taiwan in managing their trade sector during the early stages of development.

The weak state of human capital resources, as indicated by the very low secondary school enrollment rate which showed no improvement during the past fifteen years, is a major constraint to accelerated growth and development. According to the recent World Development Report, secondary school enrollment rate in Bangladesh, still at about 20 percent of the relevant age group is the lowest among the Asian economies. To address the weak state of the human capital resources and to improve the physical infrastructure of Bangladesh, the staff recommends much greater reliance on the private sector (including nongovernmental organizations). I wonder whether the staff could provide us with examples of other low income developing countries that were successful in this area. We believe that the exploitation of profitable opportunities for private investment is dependent on supporting public investment in human capital and infrastructure.

On fiscal consolidation, we welcome the shared view between the staff and the authorities, on the need for fiscal prudence as indicated in the 1996/97 budget, which envisages significantly reduced domestic financing. While efforts are needed on both sides of the revenue/expenditure equation, raising revenues should be given more weight given the very low revenue/GDP ratio—at just over 11 percent and the lowest among Asian economies. The authorities must pursue vigorously tax administration reform in parallel with broadening the tax base and eliminating tax exemptions. In this regard, we are encouraged that the legal provisions have recently been made for introducing value-added tax on retail and wholesale trade sales as noted in Mr. Sivaraman's helpful statement. On the expenditure side, it would be important that the authorities resist any pressures for higher current spending, excluding education.

On monetary policy, it is not clear from the report why the staff is recommending tighter policies. By end of June 1996, the 12-month growth of domestic credit was about 20 percent according to Table 4 of Supplement 1. However, if bad loans and capitalization of interest arrears are excluded from the claims on the private sector, the expansion in domestic credit would be only 12 percent as reported in the *International Financial Statistics*. Moreover, average real lending rates, at about 9 percent, appear excessive. Staff comments would be appreciated.

With these remarks, we wish the Bangladesh authorities every success.

Mr. Ono made the following statement:

Regrettably, because of political uncertainty the Bangladesh authorities in recent years have not implemented economic reform extensively enough to attain noninflationary growth.

The new government has begun to implement the 1996/97 budget. I strongly hope that this new government will demonstrate a strong commitment to economic reform so as to be able to achieve economic growth and poverty reduction at the same time. While I broadly share the staff's view on the policy direction that the authorities should take, I would like to stress some of the points that I consider most important.

First, on fiscal policy, it is welcome that the 96/97 budget was formulated with noninflationary growth and poverty reduction as the key objectives and that the budget deficit will be reduced, albeit modestly. The budget does have a problem, however, in that it does not contain adequate measures to address such weaknesses as public enterprise losses, the financial institutions' problems, and inadequate investment in physical and human capital. Another shortcoming of the budget is that by extending tax holidays and raising exemption limits for individual income tax, the tax base could be reduced. In order to improve the quality of budget performance, the authorities should make an effort to enhance revenue collection through expanding the tax base.

To secure long-term economic growth, it is imperative to press ahead with structural reform. In this regard, I urge the authorities to step up their efforts to reform the banking sector through restructuring troubled banks and strengthening bank supervision. This effort has to be combined with enterprise restructuring and privatization. The authorities should also take actions to reduce the role of the public sector, as this will eventually lead to a revitalization of economy as a whole.

In sum, I hope that the authorities will take further steps toward economic reform and steadily achieve economic growth as well as a reduction in poverty.

Mr. Al-Turki made the following statement:

The Bangladesh economy is at a crossroads. The stabilization and reform momentum of the early 1990s slowed in the wake of domestic uncertainties and natural disasters. I agree with Mr. Sivaraman that the continued output expansion has shown the economy's resilience in a difficult situation. However, the underlying situation has indeed worsened. Clearly, a course correction is critical now to restore conditions favorable to sustained growth.

It is thus encouraging that the domestic uncertainties have ended. It is also reassuring that the authorities are ready to seize the moment and take advantage of the consensus for reactivation of the adjustment and reform effort. Since I am broadly in agreement with the staff's recommendations, I will only touch on the some issues for emphasis.

Strengthening the government's fiscal position is appropriately at the top of the renewed policy agenda. This year's budget aim is to lower the deficit mainly through restraints on current spending. On the revenue front, the tariff reduction is a move in the right direction. I also welcome the steps toward introduction of value-added tax. I agree with the staff that the budget reduction goal will require a considerable effort. It is thus reassuring that the authorities are ready, if necessary, to initiate additional cuts in nonpriority spending.

I commend the authorities for moving on to a proactive policy stance in a relatively short time. For the medium term, the focus is rightly on a more ambitious and comprehensive approach commensurate with the fiscal situation. Given the limited prospect for new revenue initiatives, the emphasis has to remain on cuts in expenditures and the domestic bank financed deficit. In this regard, containment of both wages and budgetary support of public enterprise losses is a priority.

The fiscal restraint has to be accompanied by a suitably tight monetary policy. An early transition to an independent and effective role for the central bank is important in that regard. Further, I urge a speed up of the agenda for financial sector reform. Priority has to be given to restructuring problem banks and moving toward fully market-determined rates of interest.

The staff has rightly noted that technical assistance is central to a reform agenda's success. Indeed, the considerable progress so far in developing the economy's institutional infrastructure reflects a history of collaboration with the Fund and the World Bank. I fully support continuation of such assistance. It is, however, important to avoid overtaxing the economy's absorptive capacity.

With these remarks, I wish the authorities every success in the challenging tasks ahead.

Mr. Cailleteau made the following statement:

The staff has provided us with several good reports, well complemented by Mr. Shaalan's excellent preliminary statement.

The question of why Bangladesh has not achieved a markedly higher growth path, despite a rather successful adjustment record is now well documented. I believe that financial sector reform is of crucial importance for increasing growth prospects. It is, indeed, urgently needed since serious problems that affect resource allocation and discourage investment remain. The cost of financial intermediation is still high, and it is worth noting that the reduction in the interest rate spread between loans and deposits has not been significant enough to elicit substantial private investment, which is stuck at last year's level.

The size of the interest rate spread certainly plays a role; at the same time, it is somewhat surprising that investment is lagging while real lending rates are in the range of 5 percent. The marginal rate of return in an economy such as Bangladesh is usually higher than 5 percent. This situation underlines, beyond the question of the cost of intermediation, the degree of microeconomic impediments to better access to credit facing economic agents.

In addition, it is disappointing to note that the ratio of private savings-to-GDP is now expected to decline to pre-1993 levels. I recall that, during the 1995 Article IV discussion, the staff noted that private savings had responded to financial reforms, such as the lifting of controls on interest rates paid on deposits. I would welcome the staff's explanation of these disappointing developments.

Lastly, with respect to the exchange rate policy, I found the authorities' arguments paradoxical: they "see merit in greater flexibility...but consider it risky to change the currency stand before a more comfortable reserve level could be restored." I agree with the staff that a more flexible exchange rate would be appropriate in the case of Bangladesh, and the debate on the speed of the transition, as alluded to by Mr. Daïri, for instance, will be related to the strength of the commitment of the authorities to strengthen their stabilization efforts.

Mr. Austin made the following statement:

I have read the staff papers, as well as the preliminary statements by Messrs. Sivaraman, Shaalan, and Daïri, with interest. I would like to acknowledge the achievements of Bangladesh in the past year, in what have been testing economic circumstances and a background of political uncertainty. Nevertheless, I would like to echo the concerns of others about slippages in macroeconomic management, and emphasize the need to restore stability. Also, it is important to stress the importance of revitalizing the stalled structural reform agenda, which is essential if higher growth rates are to be achieved and if poverty is to be alleviated. In that context, I would welcome the views of the staff and Mr. Sivaraman on the prospects, plans, and timing of the Fund program.

The Bangladeshi authorities had some good achievements during the period 1990–94 in maintaining prudent fiscal policy, low inflation, and strong balance of payments; the record over the past two years has been rather poor by comparison. Although political disruption has contributed to this, the root cause has been policy slippage.

Coming to the recent past, the budget agreed upon recently should have gone further in restoring fiscal discipline. I agree with the staff that the budget is based on rather optimistic assumptions, both about revenue and about current expenditure restraint. We would encourage the authorities to adopt a more realistic and better prioritized development program. I would welcome the staff's or Mr. Sivaraman's views on how decisions on reductions in the ADP will be taken if those are deemed to be necessary in the second quarter of the current fiscal year.

Other Directors have stressed the crucial importance of increasing tax revenues, given the low share of tax in relation to GDP, and the need for public investment in key areas. Further expansion of the tax base, as well as improved tax administration, will be required. The United Kingdom is providing some technical assistance in this area; we hope that there will be early formulation of a credible program to improve tax administration.

There has been concern about the depletion of international reserves, and the current level of 3½ months is below the level necessary for comfort. It seems that the policy of periodic minor devaluations has proved insufficient to stem this reduction. Therefore, I agree with the staff that monetary policy needs to be tightened, along with the fiscal stance, in view of the prevailing high inflation rate.

I note the candid presentation of the difference of views between the authorities and the staff about exchange rate policy, and I have some sympathy with Mr. Cailleteau's comments about paradoxical arguments deployed by the authorities. I understand the difference centers around a question of timing of when one moves to a more flexible arrangement, and this will certainly be an important issue to resolve in any program negotiations.

Progress with structural reform has slowed almost to a halt. It is important that the new government move quickly and decisively—beyond broad statements of intent—to setting out and embarking on implementation of a specific action plan. I was therefore pleased to learn from Mr. Sivaraman's preliminary statement about the resumption of normal operations of the privatization board. Conditions may well be right for an ESAF, which would lend credibility to the authorities' program and provide a framework for technical assistance inputs.

This brings me to my final point concerning ownership. The new government is still in the process of formulating its policies and it is to be commended for producing a budget so promptly. Experience generally shows that successful and sustainable economic and social reform programs are characterized by a strong degree of ownership and commitment, which takes time to develop. Mr. Sivaraman's preliminary statement makes a comment about measures being taken for the establishment of a government based on national consensus. It would be interesting to have some elaboration on this point—perhaps not here, but at the forthcoming consultative meeting. With all due respect to our World Bank colleague, in relation to ownership, I look forward to read soon about the government of Bangladesh's public expenditure review and the government of Bangladesh's financial sector adjustment program, rather than those of IDA. I think this is an issue that probably both the Fund and the Bank need to bear in mind.

Ms. Zheng made the following statement:

We are sympathetic to Bangladesh's situation, as its record of favorable economic performance was interrupted by political uncertainties not so long ago. Recent actions by the new government in making bold economic reforms, including the swift introduction of a new budget and their efforts to reach political consensus, have shown encouraging signs for the economy. As expressed by the other speakers, the present task is to normalize the economy and achieve the growth momentum needed to address the country's pervasive poverty issue. Therefore, the task ahead is more of a development issue. Since other issues have been covered by my colleagues today, I will only concentrate on the issues related to development.

Economic development and an improvement in social conditions crucially depend on economic growth, which again requires economic equilibria. As observed by Mr. Shaalan, Bangladesh has done well in the latter part, but unfortunately made limited progress in achieving fast economic growth. Recent Fund studies about some fast growing Asian economies concluded that the improvement in economic productivity and efficiency, as well as outward looking economic policies, are the main factors underpinning high growth. Of course, improvement in economic productivity and efficiency is an extremely general concept, and can include exploring new productive sectors, upgrading technology and products, enhancing labor skills and entrepreneurship which in the end increase the profitability of enterprises. As Bangladesh is basically an agricultural economy, the choices may be limited. My country's experience in the alleviation of poverty in some rural areas shows that, by developing the technology behind agricultural production, it is possible to increase the value added to agricultural products. Therefore, poverty relief should place more emphasis on profit generating than on a passive assistance program. In this connection, the authorities are encouraged to take advantage of international assistance and efforts by the World Bank, Asian Development Bank and nongovernmental organizations to develop appropriate strategies for economic development. By saying this, it is also important to stress that Bangladesh faces the enormous task of building up the necessary technological infrastructure for its agriculture sector.

To secure healthy economic growth, it is important that the major economic sectors be balanced. The authorities met this condition in the past; however, the fiscal deficit in 1995 doubled and inflation surged. Therefore, fiscal consolidation is required. I am pleased to note that the new government actively considered the Fund advise on fiscal matters. The value-added tax system to be introduced this year will hopefully enhance the revenue bases. Given the lowering of tariffs, which deserves commendation, and the beginning of the value-added tax system, the authorities are encouraged to closely monitor tax collection and administration, with an emphasis on reducing tax exemptions, and take additional corrective measures to secure the fiscal target.

On the structural area, the low investment in percentage of GDP is a cause for concern, especially given the recent decline in budgetary expenditure on agriculture. The new authorities are aware of this issue, and the increase in agriculture subsidies is welcome. The authorities are also encouraged to increase agricultural investment, in particular in building up the necessary agricultural infrastructure and technological capacity. In this connection, I also share the concern of previous speakers that the high interest rate is discouraging investment, especially in the agriculture sector. Secondly, I agree with previous speakers that it is important to enhance economic efficiency by creating an environment conducive to competition so that private investment in agriculture can be encouraged. However, as the experience of Korea and some other Asian countries indicates, the state role in the economic take-off should not be neglected. We see many potential roles for the government to play in supporting key sectors and cultivating the entrepreneurship which is crucial to the success of the private sector.

In conclusion, I wish the authorities success in economic development and the alleviation of poverty.

The staff representative from the Southeast Asia and Pacific Department noted that it was somewhat difficult to measure precisely the level of credit provided to the private sector; how adjustments were made for bad loans and the provisioning for those loans needed to be reviewed. However, it was important to remember that the data on nonperforming loans had not been audited fully, and it was not clear that all banks followed the same provisioning practices. With those caveats in mind, when considering issues of demand management and monetary policy, the key data were those detailing new credit, and the figures in the staff report were good approximations. Those figures showed that financial policies had been too loose, and that was also corroborated by the fact that international reserves had declined and the inflation targets had not been met.

The staff supported the authorities' intention to tighten financial policies in 1996/97, the staff representative continued, but additional tightening might be needed to meet their inflation and international reserves targets. The authorities recognized that forecasting money demand and the relationship between reserve money growth and broad money growth were subject to error, and they had indicated that they would be reviewing developments in monetary aggregates on a quarterly basis and, if necessary, would adjust the targets.

Previous research on the relationship between investment and growth in Bangladesh showed that one of the factors accounting for the poor performance of private investment had been an insufficient availability of real credit to the private sector, the staff representative said. What was important to emphasize was that without a substantial improvement in the operation of the government accounts, it would be difficult to provide for an adequate increase in credit to the private sector that is consistent with overall macroeconomic stability. In that context, it was a cause for concern that central bank credit to the government as of mid-July 1996 had already increased by Tk 6 billion—the preliminary target in the central bank's monetary program for the entire fiscal year.

While interest rate spreads between average lending and deposit rates were high in Bangladesh, they were not the highest in the region, the staff representative pointed out. Factors contributing to the high spreads were the overall problems in the banking sector and the high cash and statutory reserve requirements, which added to the cost of intermediation. Also, judgments as to the exact level of real interest rates in Bangladesh were complicated by the fact that official indices for inflation probably underestimated inflation. In any case, increasing competition for funds had recently led to a bidding up of time deposit rates, while prime borrowers, who were lower-risk customers, received preferential rates, suggesting that, at the margin, interest rate spreads were significantly narrower than average spreads.

It was not yet clear what type of cuts would be made to the Annual Development Program (ADP) expenditures, the staff representative remarked. However, the staff would recommend an early prioritization of the projects included in the budget to ensure that higher priority development projects were fully provided for.

The authorities should continue to monitor competitiveness closely, particularly because calculations of the real effective exchange rate were not fully reliable, and exports were still in the process of recovering, the staff representative cautioned. The slowdown in exports in 1995/96 had been due mainly to reduced confidence and the closure of the main port in early 1996; however, the ready-made garment sector, which accounted for over 50 percent of exports, was described in a recent World Bank study as highly competitive, and exports were recovering. Newer exports, such as shrimp, were affected negatively by bad weather and could face trade restrictions in some markets in 1996 related to environmental considerations. Thus, while, at this point, competitiveness was not likely to be a major problem, it needed to be monitored closely.

The difference in views between the staff and the authorities with respect to exchange rate issues was not irreconcilable, the staff representative noted. Indeed, as indicated in Mr. Sivaraman's preliminary statement, the authorities had been moving toward a more market-determined system through the elimination of exchange controls; the rate was also managed flexibly because the authorities reviewed continuously the real effective exchange rate, as well as the parallel market rate. Nevertheless, the authorities had considered that switching to a more flexible exchange rate regime would not be appropriate at the moment, because destabilizing speculative capital flows might ensue and the country might be more vulnerable to external shocks, given the weak reserve position. However, the staff believed that a more market-determined rate, combined with a tightening of financial policies, would put the authorities in a stronger position to deal with such shocks, as well as help prevent a further decline in reserves and discourage exchange rate speculation. Moreover, as already noted, given the poor quality of the inflation data, it was increasingly difficult to estimate what should be the equilibrium real effective exchange rate; such a decision should be left to the market.

Mr. Daïri stated that the authorities should first implement clear macroeconomic policies before moving to a more flexible exchange rate system in order to reduce the risk of speculative attacks, which might undermine the reform efforts.

The staff representative from the Southeast Asia and Pacific Department considered that a bold new approach should be undertaken by the government with respect to structural reforms. While it was important to build up the necessary political consensus for a reform effort, the government could not afford to delay taking actions much longer.

In response to Mr. Shaalan's contention that excessive liberalization could have adverse effects, such as a surge of consumer goods imports, in a country in the early stages of development, the staff representative pointed out that it was difficult to obtain data on the precise breakdown of imports of raw materials, capital goods, and consumer goods. It was unlikely that consumer goods imports increased by 60 percent between 1989 and 1995. Indeed, most imports of textile products , which may have been classified as consumer goods, were used as inputs for the ready-made garment industry, only to be exported. Excluding such inputs, consumer goods had not increased as a percentage of total imports over the previous five years. Moreover, the pace of trade liberalization in Bangladesh had been broadly similar to those of other countries in the region, and many trade restrictions remained.

The decline in the savings rate in 1995/96 had been primarily related to political disturbances, the staff representative said. The staff's medium-term scenario envisaged a gradual recovery of private savings. However, the national accounts data were weak and greater attention would be needed in refining the staff's projections in that area.

With respect to the future relations with the Fund, the current government had yet to decide whether to request the use of Fund resources, the staff representative noted. The authorities needed first to determine their reform agenda and to develop the political consensus to support that agenda. The staff would discuss the issue further with the authorities at the aid group meeting in September 1996 and during the Annual Meetings in Washington, D.C. in October 1996. Meanwhile, the staff stood ready to discuss with the authorities a comprehensive reform agenda that might be suitable for support by an ESAF arrangement; such discussions might begin in October or November 1996. However, it was important to remember that the authorities needed to act quickly in order to ensure that macroeconomic stability was maintained and poverty reduced. In particular, quick action was needed in the area of financial sector reform and the related problem of the public sector enterprises that had large nonperforming loans with the banking system.

Mr. Shaalan explained that he had questioned the wisdom of tightening monetary policy because of the fragile health of the banking system. The staff was correct to point out that the conceptual definition of net credit to the private sector was difficult to determine, particularly because of the limited availability of proper data. That underscored the importance of the staff in area departments working closely with the Statistics Department to harmonize the Fund's statistics. He said that his own calculations indicated that net domestic credit had expanded by 12 percent in 1995/96, but the staff had cited a larger figure. Similarly, inflation for 1995/96 might have been lower than the staff had estimated, and the shortfall in the level of international reserves might have been adversely affected by lower aid disbursements. As a result, the staff's suggestion to tighten monetary policy might not be appropriate.

The staff representative from the Southeast Asia and Pacific Department stated that harmonizing statistics across the departments of the Fund was an important task, but it would take some time. The staff recognized that the banking system in Bangladesh was fragile. In fact, that had been a key consideration leading the staff to recommend a balanced policy mix that included greater fiscal consolidation and a more flexible exchange rate, as well as tighter monetary policy.

Unfortunately, it was not clear what the precise level of inflation was at present, and, while it might be falling, it was probably still too high, the staff representative stated.

While it was true that a main factor contributing to the fall in international reserves in 1995 had been lower aid disbursements, the balance of payments projections for 1996 based on the current policy stance suggested that reserves might continue to fall. Indeed, much of the aid disbursement was conditional on the implementation of structural reforms, which underscored the importance of accelerating the reform program.

Mr. Sundara made the following statement:

The June 1996 election marks the end of the prolonged period of political instability which eroded Bangladesh's success in macroeconomic stabilization of the early 1990's and stalled the reform process. Now that the political environment has strengthened, the new government needs to exert strenuous efforts to adopt and implement a bold framework of policies and measures to restore macroeconomic stability and accelerate structural reforms, in order to place the economy on a path of higher noninflationary growth and reduce the pervasive poverty, afflicting nearly half of the population.

On the fiscal front, the policy of fiscal prudence and low inflation within the context of the 1996/97 Budget which aims at a deficit reduction of ½ percent of GDP is a step in the right direction. However, considering the difficulties during this early stage of political consolidation, both in raising the tax ratio/GDP and in current expenditure restraints, I would therefore urge the authorities to reprioritize upfront the Annual Development Program expenditures with the World Bank assistance. In addition to the agricultural sector projects, I stress the need to divert more resources on priority physical infrastructure and human resource development projects, while delaying less essential ones..

The fiscal efforts need to be supported by monetary tightening. In line with the 1996/97 monetary program which targets a 13 percent increase in broad money, the central bank needs to be firm in pursuing credit restraint, both to the budget and the banks. Furthermore, interest rates should be market-determined to promote savings and investment, and to direct government borrowings to domestic nonbank sector. The central bank should also be given greater independence to facilitate the use of indirect instruments in its conduct of the monetary policy.

The conduct of the exchange rate policy needs also needs to aim principally at stemming inflationary pressure. Like Mr. Daïri, I feel that the move toward a market-determined exchange rate can wait until financial policies tightening is effectively in place. The Bangladesh Bank needs to be comfortable with the level of reserves, while competition in the weak banking system also needs to be improved in order to ensure an effective operation of the foreign exchange interbank market. In the meantime, I continue to see the merit of the current system which allows for small infrequent adjustments to the exchange rate on the basis of the movement of the real effective exchange rate to ensure the relative stability of the taka to promote foreign direct investment.

On the structural front, in order to place Bangladesh on a path of higher GDP growth of 7–8 percent, a more ambitious structural reform agenda is required, to raise the investment/GDP ratio to a higher level—close to 20 percent over the medium term. I concur with the staff that this agenda should attach priority to the reform of the weak financial sector, and public sector restructuring and privatization. In this connection, I am encouraged by the pronouncement of the government's intention regarding a fundamental rethinking about the role of the government. I, therefore, urge the authorities to effectively translate this intention into actions. The currently very large involvement of the state in the economic activities needs to be reduced through accelerated privatization, including the privatization of the state-owned banks, in order to make way for greater private sector participation, using capital from both domestic and foreign sources.

With these remarks, I wish the authorities every success in meeting their challenging tasks ahead. This success could not, of course, be realized without the authorities ability to garner the prerequisite political consensus and the continued flow of external assistance.

Mr. Rigász made the following statement:

After more than two difficult years of political transition, Bangladesh again has a window of opportunity to address the deep rooted structural problems that have long blocked its effort to achieve significantly stronger growth rates. The June elections have brought a new political reality, and since Bangladesh's macroeconomic imbalances should in principle not cost too much to correct, it may be possible for the new government to take a bolder approach to the implementation of its reform plans. We hope the new government fully aware of how Fund support can aid this process, and we hope that we will soon be able to discuss a structural adjustment program for Bangladesh in the Board. Since I generally agree with the staff's analyses and recommendations, I have only two remarks, the first on reforming the financial system, and the second on the poverty issue.

The World Economic Outlook paper just released contains a section on financial system requirements in countries lagging behind. There it is stated that a well-developed financial sector contributes to growth by mobilizing savings and then efficiently allocating them among competing investment projects and other demands for funds. This is clearly substantiated by Chart 27, which shows that indicators of financial development are positively correlated with long-term growth for a large sample of developing countries. We therefore fully support the staff's call for giving financial sector reform a high priority on the government's agenda. Early action is all the more crucial since the present weakness of the financial system not only hinders economic growth but also seriously undermines durable macroeconomic stability: it significantly distorts the transmission mechanisms on which monetary policy depends, and constantly threatens to add large fiscal liabilities to the budget. A package of specific measures to address these issues is spelled out in the staff report, and we fully endorse them.

Given the dire situation reflected by Bangladesh's social indicators, it is certain that a conventional social safety net can do little toward the general alleviation of poverty. In a country where 50 million people live below the poverty line, the only viable strategy for durably improving living standards is a significant acceleration of economic growth. The staff states, in its Selected Issues paper, that Bangladesh would probably need a real GDP growth rate of at least 7 percent in order to make a major breakthrough in poverty reduction. The statistics indicate that the absolute numbers of the poor have grown every year since independence. These increases have occurred despite the average real growth of 4 percent during the 1980s and of 4.5 percent during the last five years. The staff appraisal for a World Bank Poverty Alleviation Microfinance Project in Bangladesh seems to agree, since it expects that a growth rate of over 5 percent will not be enough to provide productive employment for all new entrants to the labor force. The Bank's projections show that in coming years, 35 percent of new entrants into the labor market will find very limited job opportunities and accordingly will probably swell the ranks of the very poor. Based on this, I find that a 7 percent growth rate is the minimum required to reverse the negative poverty trends, although most probably, giving due considerations to financing constraints, a faster growth rate would really be needed to deliver tangible results in the government's fight against poverty.

Having said this, I wish the authorities all the best in their endeavors.

Ms. Brettschneider made the following statement:

We welcome today's discussion of developments in Bangladesh, particularly given the delay in holding the 1995 Article IV consultations. Like previous speakers, we are encouraged that the political environment seems to have settled somewhat under the newly elected government, which we hope will allow a renewed focus on the immense economic challenges at hand. The staff has produced an excellent set of papers detailing those challenges, which, regrettably, appear to have intensified over the past year with the continuation of the political impasse and complicated further by a recurrence of natural disasters.

The priority issues identified in earlier discussions remain generally the same at the current juncture, although the road to their resolution has become steeper in many respects. These encompass, as others have already noted, the need to boost significantly savings, investment and growth to levels that will eradicate the widespread poverty and improve the extremely poor social indicators with which Bangladesh has unfortunately come to be associated. Our views on these issues are very much in line with the staff's, and remain the same as those we expressed in some detail at last year's discussion. Other speakers have already addressed the key policy areas needing attention. I would therefore only like to add my voice to my colleagues' calls for determination on the part of the new authorities to tackle boldly the financial imbalances and deep-seated structural rigidities that have prevented Bangladesh from reaching its potential.

The recently announced 1996/97 budget provides some hopeful signs that the new regime is committed to the right course of action. We will be following developments closely, however, as the new authorities articulate in more detail how they intend to get from point A to point B. Given the uncertainties about the feasibility of the new budget meeting the authorities' stated objectives—and, I would add, we share the staff's concerns in this regard—we were encouraged by Mr. Sivaraman's assurances that the authorities will consider corrective measures in the second quarter of the fiscal year if performance falls short of expectations.

In the meantime, we hope the staff will stay in close contact with the authorities, both through discussions at the Annual Meetings and subsequent missions to provide whatever support the authorities need as they formulate their medium-term strategy. We hope the end result will be a program that could be supported by Fund resources. I appreciated Ms. Kelly's additional remarks on this point.

I would close by commending the staff on the selected issues papers. I found the paper on poverty to be particularly relevant in highlighting the enormity, and complexity of the poverty problem in Bangladesh. With roughly half of the population below the poverty line no matter what measure is used, and income disparity rising, there can be no greater priority for the Bangladeshi authorities and the donor community as a whole than poverty reduction. In that regard, the statement in the paper that micro-credit programs are generally considered to have had a positive impact on rural incomes, educational opportunities, advancement of women, and employment of the poor deserves to the highlighted. We hope to see continued progress via these innovative routes. I also found Ms. Zheng's insights on China's experience with agricultural reform and poverty alleviation very interesting.

With these remarks, I wish the authorities success in addressing their very broad and challenging policy agenda.

Mr. Sivaraman made the following statement:

I would like to thank all my colleagues for the constructive suggestions they have given, and I would like to express my great appreciation to the staff for the lucid explanation they have given to the various complicated queries raised here.

From the tenor of discussion, I see that my colleagues have expressed concern on a number of issues, including: the slow progress of financial sector reforms and the need to expedite it; the need to keep a careful watch on the monetary situation; the importance of containing the fiscal deficit and improving the collection of revenues by further expanding the tax base and to undertake any midcourse corrections, if warranted; the improvement of the productive capacity of the economy in order to enable the private sector to participate effectively in the development of the country; the restructuring and privatization of the public sector in order to improve its efficiency, which is at a low ebb; the need to move toward a market-determined exchange rate quite steadily; and lastly, to lay emphasis on the development of human resources.

While going through the budget speech of the finance minister to the Parliament for the current year, I noticed that my authorities have addressed many of the concerns expressed here, and they have affirmed their commitment to follow a policy which will achieve macroeconomic stability and put Bangladesh on a sustainable growth path.

As regards the inadequacies in the statistics, I have been informed by my authorities that they are taking steps to improve the collection and methodology of statistics so that they have a better statistical base and they come in line with the statistical base found elsewhere.

The 1996/97 budget of the government of Bangladesh substantially increases the allocation for agriculture; it also expresses serious concern at the shortfall in agricultural production and emphasizes the need to improve agricultural technology.

As regards the cuts in ADP, I am informed by my authorities that they are carefully watching the situation, and as they presented the budget only in late July 1996, they will review the situation by the end of December and try to take the necessary steps so that stability is maintained.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. Directors welcomed the opportunity the authorities now had to adopt significantly bolder policies than had been possible during the prolonged period of political uncertainty. Directors emphasized the need for reforms to restore macroeconomic stability, raise the growth rate, and reduce the high level of poverty. They urged the authorities to seize the opportunity provided by the present consensus on reforms to revitalize the reform agenda—most important, a fundamental overhaul of the role of government and financial sector reforms. Such reforms were necessary to create the conditions conducive to private enterprise and investment, which was low relative to rates prevailing in other fast-growing economies in the region.

Directors were of the view that a strengthening of fiscal policy should be a central element of the adjustment effort. While the aims of the 1996/97 budget appeared to be appropriate, Directors noted that there were considerable risks of slippage in budget implementation as measures were not in place to achieve the budget estimates, which had been based on optimistic assumptions. They therefore emphasized the need for the government to resist pressures for higher public sector wages, to make timely cuts in low-priority domestically financed expenditure, and to be ready to implement additional measures. Directors suggested that more attention should be given to the revenue side, in view of Bangladesh's relatively low revenue/GDP ratio. The authorities should pursue vigorously tax administration reform, a broadening of the tax base, and elimination of tax exemptions. In pursuing fiscal adjustment, due attention should be given to human capital development.

On monetary policy, Directors stressed the importance of ensuring that domestic credit growth was reduced as envisaged in the authorities' monetary program for 1996/97. That would require reducing the expansion of bank borrowing by the government and curbing central bank lending to banks and specialized institutions. In that context, Directors pointed to the need for a more independent and effective role for the central bank. Despite recent steps to liberalize interest rates, Directors noted the need to further increase interest rate flexibility by eliminating the remaining interest rate ceilings and floors. Directors stressed that the authorities should be prepared to tighten their monetary targets for 1996/97, if needed, to help bring about the desired reduction in inflation and to strengthen the international reserve position.

Directors generally encouraged the authorities to adopt a more market-based exchange rate regime in conjunction with the proposed tightening of financial policies. In their view, that would help to prevent a further decline in reserves and help the conduct of monetary policy while avoiding recourse to administrative controls on imports.

Directors observed that prolonged delays in implementing structural reforms were an important reason for the economy's lackluster growth performance over the past few years. They considered that top priority should be given to the early reform of the closely related financial sector and public enterprises. Thus, while welcoming ongoing improvements in bank supervision, they urged the authorities to expedite implementation of plans to restructure the banking system, including by privatizing nationalized banks and providing a lasting solution to the problem of private banks. Noting the large losses in the public enterprise sector, Directors urged the authorities to proceed quickly to develop a comprehensive program of reform and privatization.

Directors observed that maintaining macroeconomic stability and establishing a strong track record of fundamental and sustained reforms would help Bangladesh to restore the confidence of the donor community and, thus, mobilize the needed external assistance. Directors noted the authorities' intention to work closely with the staff to develop a comprehensive reform program that could be supported by the use of Fund resources.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/79 (8/26/96) and EBM/96/80 (8/28/96).

5. TECHNICAL ASSISTANCE—FRAMEWORK ADMINISTERED ACCOUNT—ESTABLISHMENT OF SWITZERLAND TECHNICAL ASSISTANCE SUBACCOUNT

In accordance with the terms and conditions of the Instrument establishing the Framework Administered Account for Technical Assistance Activities (Decision No. 10942-(95/33)), as amended, the Fund hereby approves the establishment of the "Switzerland Technical Assistance Subaccount," which shall be used by the Fund to administer resources to be contributed by the government of Switzerland, as described in EBS/96/132 (8/20/96).

Decision No. 11331-(96/80), adopted
August 27, 1996

6. FORTHCOMING ANNUAL MEETINGS—GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/96/79, Sup. 2, 8/27/96) on the canvass of votes of the Governors on Resolution No. 51-2, with respect to the forthcoming Annual Meetings of the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes	1,447,062
Total negative votes	0
Total votes cast	1,447,062
Abstentions recorded	0
Other replies	0
Total replies	1,447,062
Votes of members that did not reply	46,269
Total votes of members	1,493,331

Decision No. 11332-(96/80), adopted
August 27, 1996

7. RULES FOR 1996 REGULAR ELECTION OF EXECUTIVE DIRECTORS—GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBD/96/97, Sup. 1, 8/27/96) on the canvass of votes of Governors on Resolution No. 51-3, with respect to the Regulations for the Conduct of the 1996 Regular Election of Executive Directors, approved by the Executive Board (EBM/96/71, 7/24/96) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

Total affirmative votes	1,448,040
Total negative votes	0
Total votes cast	1,448,040
Abstentions recorded	0
Other replies	0
Total replies	1,448,040
Votes of members that did not reply	45,291
Total votes of members	1,493,331

Decision No. 11333-(96/80), adopted
August 27, 1996

8. RULES AND REGULATIONS AMENDED SINCE 1995 ANNUAL MEETING

The Executive Board approves the letter to the Chairman of the Board of Governors submitting for review by the Governors the texts of amendments to the Rules and Regulations adopted since the 1995 Annual Meeting and the proposed resolution for the Board of Governors, as set forth in EBD/96/108 (8/22/96).

Adopted August 27, 1996

9. EXECUTIVE BOARD COMMITTEES—NOMINATION

The Executive Board approves the nomination by the Managing Director for the vacant positions on the Committee on the Budget, the Committee on Executive Board Administrative Matters, and the Committee on Interpretations, as set forth in EBD/96/109 (8/22/96).

Adopted August 26, 1996

10. EDUCATION ALLOWANCE—CONDUCT OF REVIEW

1. Authority to approve the annual adjustment to education allowance ceilings shall be attributed to the Managing Director, subject to application of the procedures outlined in EBAP/93/79 (12/2/93).

2. The procedures for adjusting education allowance ceilings shall be reviewed on a quadrennial basis by the Committee on Administrative Policies for recommendation to the Executive Board, beginning with the review of ceilings for the academic year 2000/01. (EBAP/96/90, 8/22/96)

Adopted August 27, 1996

11. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/96/141 (8/26/96) and by Assistants to Executive Directors as set forth in EBAM/96/139 (8/21/96) and EBAM/96/140 (8/21/96) is approved.

APPROVAL: May 1, 1997

REINHARD H. MUNZBERG
Secretary