May 5, 1997
Approval: 5/12/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/118

10:00 a.m., December 13, 1995

Contents

Executive Board Attendance

M. Camdessus, Chairman
A. D. Ouattara, Acting Chairman

Executive Directors	Alternate Executive Directors
A. A. Al-Tuwaijri	
M.-A. Autheman	A. Fayolle
	P. Cailleteau, Temporary
	E. Srejber
	B. Andersen, Temporary
L. E. Berrizbeitia	
I. Clark	C. X. O'Loghlin
	N. Laframboise, Temporary
	J. M. Jones, Temporary
H. Evans	J. Shields
	A. G. Cathcart, Temporary
K. P. Geethakrishnan	
	N. Coumbis
	J. C. Martinez Oliva, Temporary
	R. Bessone Basto, Temporary
	M. Giulimondi, Temporary
	L. M. Cheong
	R. F.Cippa, Temporary
D. Kaeser	
	A. L. Coronel, Temporary
W. Kiekens	J. Prader
	J. Jonáš
	H. A. Barro Chambrier
	S. N'guiamba, Temporary
K. Lissakers	B. S. Newman
	J. M. Abbott, Temporary
H. Mesaki	S. Fukushima, Temporary
A. Mirakhor	M. Daïri
	S. Rouai, Temporary
C. Saito	J. Leiva, Temporary
S. Schoenberg	B. Esdar
	Y. Y. Mohammed
D. V. Tulin	A. Vernikov, Temporary
	J.-H. Kang
	M. Petrie, Temporary
	O. Havrylyshyn
	P. I. Botoucharov, Temporary
	G. A. Kyriacou, Temporary
	Wei B.
	Song J., Temporary

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

Also Present

IBRD: S. Fardoust, Asia Regional Office. Administration Department: K. B. Dillon, Director; U. Baumgartner, Deputy Director; M. E. Gehringer, J.-P. C. Golle, J. P. Kennedy. Central Asia Department: R. J. Lipworth. European I Department: M. Russo, Director. European II Department: E. Brau, Deputy Director. External Relations Department: P. C. Hole, Deputy Director; D. R. Hawley, S. W. Kane. Fiscal Affairs Department: K.-Y. Chu, S. A. Symansky. IMF Institute: C.-H. Wong, Deputy Director; S. M. Thakur. Legal Department: A. O. Liuksila, L. E. Nordgaard. Middle Eastern Department: P. Chabrier, Director; M. El-Erian, Deputy Director; M. D. Knight, Deputy Director; S. J. Fennell, A. C. A. R. Furtado, G. M. Iradian, O. Liu, E. Maciejewski, R. Moalla-Fetini, S. E. Williams. Monetary and Exchange Affairs Department: M. Saal. Policy Development and Review Department: D. N. Lachman, S. V. Dunaway, F. Kaune, A. C. Kouwenaar, J. Pujol. Research Department: M. Mussa, Economic Counsellor and Director; M. S. Khan, Deputy Director; P.-R. Agenor, M. M. Cassard, Chen Z., D. Folkerts-Landau, R. D. Haas, N. U. Haque, R. Hauswald, T. Ito, S.-j. Kim, L. E. Cadres, M. S. Kumar, J. Montgomery, G. J. Schinasi, B. Simmons, T. Smith. Secretary's Department: W. Tseng, Deputy Director; B. R. Hughes, A. Mountford. Southeast Asia and Pacific Department: M. R. Kelley, P. Reynolds. Statistics Department: J. B. McLenaghan, Director. Treasurer's Department: J. E. Blalock, I. Otker. Western Hemisphere Department: O. Gronlie. Bureau of Language Services: P. Delannoy, Director. Office of the Managing Director: J. Quick, Personal Assistant; Office of Budget and Planning - L. A. Wolfe, Director; J. G. Blanch, C. W. Diener, F. Gaitan, F. Khan, P. J. McClellan, P. J. McPhillips, M. Oka, H. Wiesner; A. Coune; J. Prust. Advisors to Executive Directors: J. M. Abbott, R. F. Cippa, S. S. Farid, R. Kannan, M. H. Mahdavian, M. F. Melhem, H. Mori, G. Mucibabici, S. O'Connor, T. Oya, R. von Kleist. Assistants to Executive Directors: S. Al-Huseini, C. Austin, M. A. Brettschneider, J. Dagustun, J. C. Estrella, A. Galicia, C. M. Gonzalez, B. Grikinyté, A. Guennewich, R. J. Heinbuecher, P. Jilek, W. C. Keller, A. M. Koulizade, T.-M. Kudiwu, N. Laframboise, B. M. Lvin, J. A. K. Munthali, M. Nemli, Ng C. S., J. Pesola, N. Prasad, A. Ruocco, M. W. Ryan, D. Saha, K. Sakr, S. Simonsen, Y. Tahara, V. Trivedi, Zheng H., Zubir bin Abdullah.

1. PAKISTAN - 1995 ARTICLE IV CONSULTATION; AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with Pakistan (SM/95/298, 11/28/95) and Pakistan's request for a 15-month stand-by arrangement in an amount equivalent to SDR 401.85 million (EBS/95/208, 12/5/95; and Cor. 1, 12/12/95). They also had before them a background paper on recent economic developments in Pakistan (SM/95/305, 12/8/95).

The Deputy Director of the Middle Eastern Department said that some notable developments had taken place in Pakistan since the staff report was circulated.

First, recent indications suggested that, although the foreign exchange markets were still fragile, capital outflows were subsiding, the Deputy Director stated. Thus, after some substantial outflows, particularly in the week of November 23-30, 1995, when capital outflows had amounted to about $196 million, there had been net inflows of $69 million into foreign currency accounts during December 7-12. In addition, the State Bank of Pakistan's provision of foreign exchange on account of trade transactions had remained in balance since mid-November, following the corrective policy measures. That compared with previous outflows of about $200-250 million a month.

Second, gross international reserves amounted to $1.19 billion as of December 12, 1995, compared with $1.07 billion in the previous week, which was a gain of $118 million, the Deputy Director noted.

Third, recent indicators on agricultural production were encouraging, the Deputy Director considered. Most important, deliveries of raw cotton by farmers were running well ahead of the levels achieved in 1994. Outside observers expected that the authorities' target of 9.5 million bales, indicated in the staff report, would be met, if not exceeded.

Finally, the State Bank of Pakistan had taken additional steps on December 11, 1995 to further tighten monetary and credit conditions, and reinforce the emerging turnaround in the financial position, the Deputy Director of the Middle Eastern Department said. First, it had raised its repo rate by a further 1/2 of 1 percent to 17 percent, effective immediately. Second, it had imposed a special reserve requirement of 3.5 percent on commercial bank rupee deposits that would come into effect on December 19, 1995.

Mr. Mirakhor made the following statement:

> After a year of good economic performance in 1993/94 under a program supported by a stand-by arrangement and subsequent arrangements under the enhanced structural adjustment facility (ESAF) and the extended Fund facility (EFF), macroeconomic imbalances re-emerged in 1994/95. The inflation rate remained

high, as the impact of a lower-than-projected rate of economic growth was compounded by a higher-than-targeted rate of monetary expansion. Aggregate demand pressures and the hardening of inflationary expectations led to a widening of the trade deficit, with resulting pressures on the exchange rate and international reserves. The authorities continued their close dialogue with the staff and, during the 1995 Annual Meetings, discussed a set of measures to be implemented to stabilize the economy and pave the way for a return to a medium-term program of adjustment and reform. Toward this end, the authorities implemented a number of measures in late October and early November. Further discussions in mid-November led to the program before the Board today. What follows briefly reviews developments in 1993/94 and 1994/95, as well as the salient features of the authorities' program to be supported by the proposed stand-by Arrangement.

In 1993/94 Pakistan embarked on a comprehensive medium-term program. Tight financial policies were combined with a set of structural reforms that included rapid reduction of the maximum tariff rate, introduction of an agricultural wealth tax, high returns on financial instruments, a far-reaching privatization program, and liberalization of the exchange and payment system leading to full current account convertibility of the rupee. The authorities succeeded in achieving the program's fiscal target and slowing growth in domestic credit. They also made notable progress in the external sector with the lowering of the current account deficit, and a substantial increase in international reserves. However, mainly due to the effects of adverse weather conditions and crop disease on agricultural output, and the related weak performance of industries reliant on agricultural inputs, limited progress was made in reviving growth and reducing inflation.

The program for 1994/95 sought to raise GDP growth to 6.6 percent, decrease inflation to 7 percent, and boost international reserves to about 14 weeks of imports. To achieve these objectives, the authorities aimed at decreasing the budget deficit to 4 percent of GDP, slowing monetary growth to 11.9 percent, and narrowing the current account deficit to 3.1 percent of GDP. The program's structural dimension included: broadening the privatization program, further progress on tariff reform, and reducing impediments to market-based allocation of credit. The program, however, could not be implemented uniformly in 1994/95. Continuing poor weather conditions and crop disease remained important factors affecting growth and inflation, as were difficult non-economic circumstances. In addition, administrative hurdles encountered in broadening the general sales tax and difficulties in reducing exemptions and concessions led to considerable revenue shortfalls. In the event, economic performance fell considerably short of the programmed targets; the budget deficit was only marginally lower at 5.6 percent of GDP, and monetary growth remained at 16.6 percent due to bank financing of the fiscal deficit and government-directed credit programs. As a result, inflation and economic growth rates were 13 and 4.7 percent, respectively.

At the time of submission of the 1995/96 annual budget to the Parliament, the authorities were faced with a difficult situation, including continued poor output performance of agriculture and slow progress with administrative preparation to allow for the broadening of the general sales tax. Given the large fiscal effort required to achieve a 4 percent budget deficit, and the large up-front inflationary impact of the necessary measures, the authorities targeted a less ambitious fiscal outcome for 1995/96 as well as a slower pace of structural reform. During the first quarter of 1995/96, there was a marked deterioration in the trade account, representing both a large expansion of imports and a decline in exports. This, together with lower remittances and heavy debt repayments, led to a sharp decline in gross official reserves.

To stabilize the economy, the authorities adopted in late October and early November 1995 a stabilization and reform package. The program's major objectives are a growth rate of 5.5 percent in 1995/96, inflation rate of 9 percent, and a recovery of gross international reserves to about 9 weeks of imports. To achieve these, the program aims at lowering the budget deficit to 4.6 percent of GDP in 1995/96, and reducing domestic liquidity growth to 12.1 percent. To this end, the authorities have adopted fiscal measures yielding about 1.1 percent of GDP in the remainder of the fiscal year, including petroleum price adjustments, higher import taxation and reductions in noncore expenditure. In addition, monetary policy has been tightened by upward adjustments in interest rates--including an increase of 1 percent in the State Bank of Pakistan's repo rate--the floor on concessional lending by commercial banks has been raised to 14 percent, and the rupee has been devalued by 7 percent. To support their adjustment effort, the authorities have requested a 15-month stand-by arrangement.

While the emphasis of the 1995/96 program is on macroeconomic stabilization, it does incorporate measures to intensify structural reforms, particularly in the fiscal area. The latter is important not only from a medium-term perspective but also because the regulatory duty of 10 percent on imports runs counter to the longer-term structural reform agenda. The structural reform measures to be implemented during the course of the program include broadening of the general sales tax, doubling the rate of agricultural wealth taxation, removal of tax exemptions and concessions, and tariff reform.

I realize that the above brief review of the evolution of economic policy management in Pakistan in the last two years invokes a question regarding the chances of success of the present program. At least three considerations are relevant in this context. First, there has been a considerable improvement in the outlook for agricultural production, particularly of the cotton crop. Second, the Government's experience with the less ambitious adjustment and reform path has convinced it that there is no easy road to sustained, non-inflationary growth and, therefore, it has committed itself with renewed vigor to a tough policy package of fiscal consolidation, monetary restraint, and structural reforms as contained in the program before the Directors today. Third, the policy environment has changed for the better. In the fiscal area, a major weakness of the Government's program in 1994/95 had been its inability to put in place rapidly the needed administrative machinery that would permit implementation of its policy objective of converting the general sales tax into a broad-based value-added tax. Combined with a long list of exemptions and concessions, this had seriously affected the ability of the Government to increase the revenues required to allow implementation of, inter alia, an ambitious program of tariff reform. With the technical assistance from the Fund, this is no longer the case and the administrative means will be in place shortly to permit generalization of the sales tax at the manufacturing and import level. Moreover, the Government is now resolved to remove all general exemptions from the general sales tax, except for a few basic necessities, as well as all specific exemptions that are part of tax incentive packages related to a sector or a region. In the monetary area, the State Bank of Pakistan has reinforced its credit control, including the setting of credit ceilings on autonomous bodies and public sector enterprises in accordance with the anti-inflation monetary policy stance. Moreover, the State Bank has largely completed the transition from direct to indirect instruments for monetary control. The credit-to-deposit ratio was eliminated in October 1995, the cap on lending rates has been removed, the Government's auctioning of treasury bills has been integrated with the State Bank of Pakistan's open market operations, the State Bank of Pakistan has gained greater flexibility in managing the rates on concessional credit, and the existing concessionary and mandatory credit schemes are being significantly reduced while no new ones will be introduced.

Let me conclude by saying that the authorities greatly appreciate the efforts of the staff in producing a high quality set of papers. They highly value the support they have received from the management and the Executive Board in the past and are grateful for the Directors' decisions to consider on an accelerated schedule their request for support under a stand-by arrangement. As always, they look forward to the Board discussion of their program. They also appreciate highly the support of the Directors for their request for use of Fund resources.

Mr. Mohammed, speaking on behalf of Mr. Shaalan, made the following statement:

After encouraging progress under the program supported by the 1993 stand-by arrangement and the structural adjustment and extended arrangements, Pakistan is again facing a difficult financial situation. The relaxation of the adjustment effort, together with adverse exogenous developments, have weakened the country's reserve position. The authorities are to be commended for their determined policy response in difficult sociopolitical circumstances. It is highly appropriate and desirable for the Fund to support the authorities' policy response through a stand-by arrangement to be followed at a suitable time by the resumption of enhanced structural adjustment and extended arrangements. This case illustrates once again the Fund's willingness and ability to react quickly to member countries' difficult situations. I commend management and the staff for their timely response.

The prior actions implemented by Pakistan are broad-based, with revenue and expenditure fiscal measures, interest rate and credit actions, and an exchange rate adjustment. The program to be supported by the stand-by arrangement is also noteworthy in its significant structural reform content. In particular, the fiscal policy actions--extending the general sales tax, broadening agricultural taxation, removing exemptions and concessions, and improving the petroleum pricing mechanism--should help address one of Pakistan's main limitations, namely, a still narrow and inelastic tax base. The need to resort to short-term measures, such as the 10 percent regulatory import duty, highlights the limited flexibility of the budget. In this context, I am pleased to learn from Mr. Mirakhor, in his helpful statement, that the necessary administrative machinery for the conversion of the general sales tax into a broad-based value-added tax is being put in place with technical assistance from the Fund. On the monetary side, the intended privatization of the United Bank and strict limitations on government-directed credit schemes will complement recent achievements in implementing indirect instruments of monetary control.

On the external front, the authorities are to be commended for accepting Article VIII obligations and for committing to intensify their tariff reform program. Like many other developing countries, Pakistan faces the prospects of considerable revenue losses as a result of a reduction in tariffs. This loss is not easy to offset in view of the need to lower the budget deficit further and increase spending on the social sectors. We would, therefore, caution against a too-ambitious tariff reduction plan lest this undermine the needed progress toward macroeconomic stabilization.

The challenge facing Pakistan is difficult and will require steadfast policy implementation. With a relatively open external payments system, significant reliance on short-term liabilities, and a much-reduced international reserve position, there is little scope for policy slippages. The early and frequent reviews contemplated under the stand-by arrangement, combined with a rather comprehensive set of performance criteria and indicative targets, will provide timely information on progress under the program.

The design of the authorities' program constitutes both an appropriate response to the country's current financial imbalances and a prelude to a medium-term program of macroeconomic adjustment and reform. The international community has an important role to play in supporting Pakistan's effort--through the provision of financial assistance on appropriate terms and through keeping markets open for Pakistan exports.

In conclusion, I have no hesitation in supporting the proposed decision. I wish the authorities success in their implementation of the program.

Mr. Schoenberg made the following statement:

I have difficulty expressing approval for a program that--after an extended period of faltering adjustment and reform efforts in Pakistan--is heavily front-loaded and includes potentially insufficient prior actions or other safeguards. In this context the fact that an obviously tricky and delicate request for a stand-by arrangement is being presented to the Board within one week of the release of the staff document did certainly not facilitate extracting a positive reaction from my authorities. In this particular case, I see the risk that the impression is being created that Pakistan is being rewarded for its discontinued efforts under the existing enhanced structural adjustment and extended arrangements by strong frontloading of the following arrangement. As far as I can see, the Fund practice in other similar cases has rather been a Fund-monitored or shadow-program in order to build first a new track record.

As to the program itself, it is a bit difficult to understand why the staff labels the program "appropriately focussed" as it admits that "the concentration of the fiscal measures--the core of the adjustment effort undertaken--on import taxation is, indeed, unfortunate."

It is also difficult to understand the staff's notion that the cause of macroeconomic imbalances has been a loosening of fiscal policy going back to 1994/95. The tables presented by the staff illustrate that the years before 1994/95 saw much higher fiscal deficits. Indeed, the problems of the piecemeal approach to reform are much more protracted than discussed in the staff papers. Especially for this reason I have been missing a longer-term and more detailed account of Pakistan's very mixed track record in its reform efforts going beyond the past two years.

Such an account would have highlighted the continuing on/off-approach of the authorities with respect to reform and adjustment and would have put the staff's conviction that the program should provide the foundation for a comprehensive medium-term program and the basis for a return to an enhanced structural adjustment arrangement into the proper perspective.

In this context, I had the opportunity to serve as a member of an economic consultative team which in 1980 spent a few months in Pakistan at the request of the Pakistani authorities. If I look at the program now being presented, I am wondering how much has changed over the last 15 years in the following areas: the inflation rate is still hovering at the 10-12 percent range; the budget deficit has been still in the range of 5-8 percent of GDP over recent years; the central bank is still offering credit to specific sectors of the economy and to public enterprises; and in the structural area the staff is still discussing with the authorities the liberalization of the trade regime, the removal of tax exemptions and proper taxation of agricultural sector, and the way the petroleum price is controlled.

These were precisely the issues we discussed already in 1980. That feeling of deja-vu raises the question of the rationale of continued Fund involvement in Pakistan; obviously the Fund has operated much less than desirable as an institution assisting in adjustment and structural reform and rather more than desirable as a cheap source of continuous financing.

Apart from these more general concerns some elements of the program in our view call for critical comments:

First, there is still large scope for improving the balance between productive and unproductive expenditures. In light of the basic needs of the country regarding education, infrastructure, etc., it is difficult to justify that development expenditures are lower than military expenditures. Unfortunately, the proposed program does not provide the framework for adjusting this imbalance.

Second, I am not quite sure whether the budget--as approved in October/November--would have allowed for the completion of the review under the abandoned ESAF and EFF programs. If not, the 1995/96 budget could not be considered a sufficient prior action for the proposed stand-by arrangement. Furthermore, I understand from the staff report that the recorded level of the fiscal deficit for 1994/95 reflects several accounting practices which have not been supported by the staff and without which the deficit would have amounted to 6.5 percent of GDP. Surely, such manipulations are not suited to enhance the credibility of the adjustment efforts.

Third, most interest rates are still negative in real terms. This has not only a detrimental effect on financial intermediation, it also endangers the effectiveness of monetary policy and the desirable increase in private savings which would narrow the gap between savings and investment. The staff report seems to indicate that limits for maximum lending rates of banks are still in place. Since such regulations are probably at the center of the problem of negative interest rates, I wonder why this important issue was not addressed in the proposed program.

Finally, it is not clear what is meant by "responsive management of the exchange rate seeking to balance maintaining external competitiveness with minimizing inflationary pressure." In the past, exchange rate policy in Pakistan has meant essentially resisting the necessary adjustment as long as possible and succumbing every two years or so to a major exchange rate hike. In a situation where the central bank is not willing or not allowed to concentrate on inflation fighting exchange rate policy cannot provide a substitute. As a result of pursuing two conflicting objectives with the same policy instrument Pakistan has neither achieved low inflation nor external competitiveness as the continuing relatively high current account deficits suggest.

Mr. Mirakhor commented that he was grateful to Mr. Schoenberg for his candid remarks, which were in keeping with the new tougher attitude of the Board with respect to countries undergoing reform programs. Nevertheless, it would be difficult to justify a general conclusion that little progress had been made in Pakistan since the early 1980s.

Even in the period since 1988, major changes had taken place in the Pakistan economy, Mr. Mirakhor noted. Enormous strides had been made in liberalizing the trade and payments system. Recent measures included the reduction in maximum tariffs from over 100 percent to 60 percent, the removal of many items from the list of negative and restricted imports, the liberalization of capital account restrictions; and the liberalization of rules governing residents' holdings of foreign exchange. There had also been a large-scale privatization of over 100 industrial enterprises and at least two nationalized banks.

The deregulation of economic activity had also included the opening up of some subsectors previously reserved for the public sector and the relaxation of sanctioning regulations on foreign and domestic investment, Mr. Mirakhor stated. There had also been substantial improvements in the financial sector, including a rationalization of debt instruments, the introduction of an auction system for treasury bills, the conversion of ad hoc treasury bills, the licensing of new banks, a reduction in the scope of concessional and preferential credits, and a strengthening of banking supervision and prudential regulation. Moreover, Pakistan was one of the few countries in its region that had an independent central bank sanctioned by law.

Government finances had also undergone significant reform, Mr. Mirakhor said. Over the past several years, the tax system had been redirected away from taxes on international trade toward greater reliance on domestic taxation through the introduction of the general sales tax and a gradual expansion of its base combined with the removal of certain tax exemptions and concessions. The law requiring the taxation of agriculture also represented a significant departure from previous practices

Although Pakistan had experienced some policy slippages over the years, it was important to recognize the significant strides forward that had been made, Mr. Mirakhor considered. It was also important to take into account the difficulties involved in undergoing strong adjustment programs in a changing environment. Both of the slowdowns that had taken place in removing tax exemptions and in reforming the tariff system had been attributable to difficulties in the agricultural sector. It had not been possible to take the necessary measures until other, offsetting revenue measurers were put in place. In the circumstances, the progress seen in Pakistan over the past several years was comparable to that achieved in any of the best-performing economies in the world.

Mr. Schoenberg commented that his statement was not intended to suggest that no progress had been made in Pakistan. However, many of the issues contained in the staff report for the 1995 Article IV consultation with Pakistan were similar to those raised in 1980.

Mr. Al-Tuwaijri made the following statement:

> The Pakistani authorities' commendable efforts in 1993/94 have led to important progress in economic adjustment and reform. Unfortunately, as these efforts were not sustained, intensification of inflationary pressures and substantial reduction in gross official foreign exchange revenues ensued. While these developments reflected, in part, the situation in Karachi as well as poor weather and crop disease, it is clear that a strong effort is needed to reduce macroeconomic imbalances and put the economy back on a sustainable growth path. Thus, I welcome and fully support the program before us as an important step toward addressing these issues.

The immediate emphasis of the program on achieving macroeconomic stabilization while intensifying structural reforms is appropriate and should facilitate a return to a new ESAF arrangement. In this regard, it is reassuring that the actions required for stabilization under the stand-by arrangement have been, for the most part, implemented. Indeed, the depreciation of the Rupee, the implementation of fiscal measures, and the tightening of credit policies appear to be succeeding in reducing domestic demand.

I am in broad agreement with the main elements of the authorities' program and therefore will only make the following comments for emphasis.

Fiscal consolidation is appropriately the cornerstone of the authorities' strategy. Their plan to reduce the fiscal deficit by a substantial amount in the rest of 1995/96 is welcome. Equally important is their commitment to improve the elasticity and transparency of revenues and to enhance the efficiency of expenditures. Such policies would facilitate a sustainable improvement in the fiscal position, stimulate private sector investments, and advance growth prospects.

On the revenue side, it is encouraging that the authorities view the regulatory duty on imports as a necessary expedient to be revoked by June 1996. It is also encouraging that the ongoing tariff reform will be advanced. It is important, however, to make sure that compensating revenue measures are firmly in place before reductions in import tariffs are effected. To this end, it is essential that the plan to generalize the general sales tax at the manufacturing and import levels by June 1996, to reduce exemptions, and to intensify collections efforts be implemented in a timely manner.

On the expenditure side, the emphasis on rationalizing current spending by containing the wage bill is important. Equally important is the increased focus on prioritizing investments in consultation with the World Bank. Such policies will facilitate a reduction in the fiscal deficit without sacrificing the capital investments required to attain the authorities' growth target.

Implementation of the fiscal measures should facilitate achievement of the monetary and inflation targets without putting undue pressure on interest rates. The recent elimination of the credit-to-deposit ratio and the further increase in lending rates under government directed schemes are important steps toward improving the allocative efficiency of credit. These measures, along with the welcome ongoing effort to privatize nationalized banks, should enhance the functioning of financial markets, strengthen confidence, and encourage capital inflows.

As regards the external sector, I welcome the authorities' commitment to advance the tariff reform in the context of the 1996/97 budget. Their plan to simplify the rate structure and reduce rate dispersion are useful steps. Turning to the exchange rate, I agree with the current policy of seeking an appropriate balance between preserving competitiveness and containing inflationary expectations. The effectiveness of this policy, however, will critically depend on timely and sustained implementation of the fiscal, monetary, and structural measures elaborated in the authorities' program.

With these remarks, I support the proposed decision.

Mr. Shields made the following statement:

I share many of the concerns expressed by Mr. Schoenberg about the proposals currently under consideration. These proposals were brought to the Board at short notice, and Pakistan's recent track record has been poor. In that respect, we could risk being seen as rewarding less than satisfactory behavior.

The proposed program is frontloaded, and there do not seem to be any great incentives within the program to improve savings. Moreover, in light of the recent track record, there are concerns about the implementation of the program.

When a Fund-supported program goes off track, it is difficult to determine the appropriate circumstances under which it should be brought back to the Board, either in its original form or, as in this case, in a somewhat modified form. Such a determination inevitably involves judgment and must take into account whether we are prepared to accept short periods of policy performance as evidence of improved behavior.

In the particular case of Pakistan, it is encouraging to note the prior actions that have been taken, and the fact that, despite the slippages that occurred earlier in 1995, there has been continued involvement by the staff in identifying ways to keep the programs from going too far off course. However, it was essentially the strong reaction of the markets to relatively small deviations from the original program that convinced the authorities to implement appropriate corrective measures. Owing to those factors, the Pakistan program did not go as far astray as those in some other recent cases. Nevertheless, it would have been preferable to take a more cautious approach by allowing more time to lapse before presenting a new program to the Board.

In light of the difficult circumstances confronting Pakistan, I am willing to support the proposed program. However, several issues remain causes for concern. For example, the proposed program provides for a large initial disbursement, presumably owing to the pressures on reserves. Nevertheless, the key forward-looking policy actions included in the program are not expected to be implemented until after the next budget is approved in April 1996, by which time about 60 percent of the disbursements under the stand-by arrangement will have been made. Some of the commitments in the program, particularly with respect to the general sales tax, have been made before, and there have been delays in implementation. It would have been better if the disbursements had been structured in a way that would have provided greater incentives to press ahead with strong reform measures. Similarly, the performance criteria on phasing out exemptions could have been made stronger, for example, by reviewing implementation of the proposals after the budget is approved.

As Mr. Mirakhor and the staff have noted, Pakistan's recent performance has been disappointing. I agree with Mr. Shaalan that the key to the success of the proposed program lies in steadfast and sustained policy implementation, with strict reviews at regular intervals against comprehensive performance criteria.

Pakistan has great potential for economic and social growth. However, despite welcome achievements under the structural adjustment program, it has, thus far, consistently underperformed. The recent World Bank country assistance strategy paper concluded that the most likely scenario for Pakistan will be one of "muddle through." This conclusion is disappointingly realistic.

The stabilization measures, both those already undertaken and those envisaged for the next six months, add up to a feasible package of reforms in the short term. I welcome, in particular, the inclusion of a quantitative target for fiscal performance that implies a deficit of about 4.6 percent for 1995/96.

But there remains an important question about implementation. This boils down to political will. Apart from problems with the cotton crop, the main obstacles to progress have been described by the staff as administrative difficulties and the reluctance of the Government to undertake as ambitious a program as required. Although the staff was correct to focus on the short-term measures now needed, it is also imperative to retain a longer-term perspective if Pakistan is to move successfully back to a program that can be supported by the ESAF within the next 15 months.

The staff report noted that energetic implementation of a package of structural reforms, as well as stabilization policies, could prepare the way for a return to an enhanced structural adjustment or extended arrangement. There are essential preconditions for such a medium-term arrangement. Specifically, we urge the authorities to accelerate the extension of the general sales tax as quickly as possible. The United Kingdom, in close collaboration with the Fund, has been providing the Pakistan authorities technical assistance in this area for some time. It will be equally important to accelerate tariff reform in order to correct recent reversals and to provide a framework for the attainment of future sustainability in government revenues. I would differ with Mr. Shaalan's call for caution in this regard. Our call on the authorities to continue the reduction of tariffs must be unequivocal. We would also underline the need for action to curtail unproductive expenditure. There has already been progress in reducing the level of military spending, and we strongly encourage further progress in this area. At more than 5 percent of GDP, military spending is clearly excessive, especially compared with expenditure on the Social Action Program, which amounts to only 2.25 percent of GDP.

I wonder whether the staff could comment on the assumptions underlying the balance of payments projections contained in the staff report. These projections indicate a continued reliance on private capital flows, including both portfolio and direct investment, as well as remittances. I wonder what level of risk is associated with these projections and whether the staff is satisfied that enough is being done to bring down these risks to acceptable levels, particularly with respect to maintaining the confidence of the private sector.

The optimistic scenario contained in the staff paper assumes a strong commitment to reduce the fiscal deficit, limit monetary growth, and maintain external competitiveness. But, the staff notes that a pessimistic scenario could rapidly become unsustainable. Thus, we are again faced with a situation in which assumptions of strong commitments are necessary in order to preclude the emergence of an unsustainable balance of payments scenario. I wonder whether we are fully prepared to prevent such an outcome.

In a similar vein, although Pakistan's debt position has been manageable thus far, clear risks to the program would arise if the balance of payments position were allowed to worsen, in particular if further recourse was made to short-term borrowing.

Finally, it is encouraging the note the cross-references made between the staff paper on Pakistan's request for a stand-by arrangement and the World Bank country assistance strategy paper. The "strategic alliance" referred to in the World Bank paper is welcome. Effective collaboration between the Fund and the World

> Bank in support of the structural reform effort is going to be the key to success. I wonder whether the staff could comment on how this collaboration process has been working and on how progress under the Fund and World Bank programs will be monitored.

Mr. Mirakhor commented that the accelerated schedule for bringing the proposed program to the Board was necessitated by the deterioration in both the reserve account and the foreign currency account in Pakistan. Indeed, the current situation was so serious that the authorities had considered requesting assistance under the emergency financing facility. It was to be hoped that the acceleration of the stand-by arrangement would produce a positive effect on confidence levels.

Decisions related to the front-loading of disbursements under Fund-supported programs were usually connected to up-front actions taken by national authorities, Mr. Mirakhor noted. Pakistan had undertaken a comprehensive package of bold reforms as prior actions under the proposed stand-by arrangement.

Mr. Shields said that, in light of the urgent circumstances confronting Pakistan and the prior actions taken by the authorities, he was willing to support the proposed program. However, such decisions required careful judgment on the part of the Board. Although significant prior actions had been taken in the case of Pakistan, there remained concerns about whether the structure of the program contained sufficient incentives for its strict implementation over the period ahead.

Mr. Schoenberg noted that, although the urgent situation confronting Pakistan might represent an emergency at the present stage, it had not emerged without warning. In that connection, the short period between the issuance of the staff report and the Board meeting was a cause for concern, because it had precluded Directors from consulting more effectively with their authorities on recent developments in Pakistan and its request for a stand-by arrangement.

Mr. Mirakhor remarked that the proposed program contained built-in incentives for the full implementation of both structural reforms and stabilization measures. More important, the Pakistan authorities hoped to put in place quickly a program that could be supported by the ESAF.

Although the international reserves crisis in Pakistan had not emerged suddenly, the current situation confronting the authorities clearly required urgent action, Mr. Mirakhor considered. If the authorities had chosen to request access under the emergency financing facility--instead of accelerating Board consideration of a stand-by arrangement--that request would have been brought to the Board at very short notice. Indeed, the need for urgent action was one of prerequisites for access to the emergency financing facility.

Mr. Newman made the following statement:

Developments in Pakistan over the last year demonstrate how quickly circumstances can turn around when countries stray from sound policies. When we last had a formal Board discussion of Pakistan in September 1994, the main debate was whether the mid-term review of the ESAF should have been completed on a lapse of time basis since all performance criteria had been met. Today, we are being asked to approve an emergency stand-by program for Pakistan to stem a hemorrhaging of international reserves that has resulted from lax policies and an unwillingness on the part of the authorities to take corrective measures when things began to go off-course earlier this year. It is unfortunate that developments have had to reach crisis proportions for the authorities to finally agree that action is needed.

This is illustrative of a broader issue that we are going to be confronting increasingly in the future. Markets are holding countries to higher standards now than even just a year or two ago, and countries that go off track are quickly going to be penalized. It also puts a premium on the need for countries to undertake reforms at a faster pace than they have been politically willing to do in the past. This is a lesson that Pakistan is going to have to learn and which we in the Board are also going to have to learn in advice that we give countries to accelerate the process, and that the laxity we have tolerated in the past may no longer be affordable, either for the country or the institution. But this is a broader issue, of which Pakistan is only the latest example.

The staff report for the Article IV consultation gives a clear picture of where the problems lie in Pakistan, and we are in broad agreement with the staff's assessment. The question is whether the authorities are ready at the political level to bring policies back on course. While the October/November policy package goes in the right direction, we have a number of questions about the prospects of this program really getting at the heart of the deep-seated inefficiencies and government controls that have been candidly described in the staff documents. I know we are faced with a situation where it is anticipated that this program will be followed by yet another program. But here I think, despite the reforms that Mr. Mirakhor has point to over the last seven or eight years, there is a legitimate concern on the part of the Board about the track record of Pakistan and the stop-go policies that have taken place.

While we recognize that external and administrative constraints have played a role in Pakistan's difficulties, the bottom line is that overshooting of the budget deficit target and excessive monetary expansion lay behind persistent high inflation, the latest surge in imports and deterioration of the balance of payments, and the decline in investor confidence.

Pakistan's fiscal problems are rooted in non-transparent budget management due to complicated federal/provincial arrangements, a tax system based on waivers and exemptions, and a heavy reliance on trade taxation. We therefore share the staff's disappointment that the package's new fiscal measures rely so heavily on import taxes, with little, if any, real progress envisioned in cutting current and unproductive expenditures. With the program targeting a fiscal deficit of 4.6 percent in 1995/96, I note that previous statements from the staff have suggested that a fiscal deficit of over 4 percent is unsustainable. In this context, I was not particularly impressed by the measures that were introduced in October/November which simply seemed to reduce the deficit by 0.6 percent of GDP in 1995/96 from staff estimates of the deficit prior to the new measures.

Intentions to eliminate the 10 percent import surcharge and broaden the base of the general sales tax to the manufacturing and import stages by end-June 1996 are welcome. However, omission of extension of the general sales tax to the retail and wholesale sectors is a gap that waters down commitments in this area. At a minimum, the plan to reach understandings on extending the general sales tax to the retail level discussed in the report should have been made a structural performance criterion. Perhaps the staff could comment on this.

It was also unclear to me the extent to which the adjustment of the land valuation factor (PIU) envisioned in the 1996/97 budget will broaden agricultural taxation. Our understanding is that the PIU adjustment would not affect a large part of the agricultural economy as most of the land owning class is still exempt from income taxes.

As a final point on fiscal issues, we are concerned by recent reports indicating that the government is considering exemptions from the capital gains tax for some sectors in hopes of boosting the stock market. Can the staff or Mr. Mirakhor comment on these reports? This would not only go against program commitments not to introduce new exemptions and concessions, it would send a very negative signal to markets about this government's commitment to reform. Such reports highlight the need for the Fund to monitor the exemption phase-out very closely.

Turning to monetary and exchange rate policy, we welcome steps to raise interest rates and to limit central bank credit to the agricultural bank and to autonomous bodies. Our understanding is that pass-through of interest rate changes is weak in Pakistan, which underscores the need for firm restraint in the volume of central bank credit. We hope the central bank now has unquestioned authority to exercise such restraint. This morning's news that reserve requirements on rupee deposits and the repo rate have been raised is certainly welcome, and sends a positive signal that the authorities are serious about monetary tightening than has heretofore been the case.

The authorities should continue to manage the exchange rate flexibly to balance the maintenance of external competitiveness of tradeable goods against the need to stem inflationary pressures. It is imperative that a tight fiscal and monetary stance is maintained to off-set the inflationary impact of possible further depreciation. I noted that the staff projects there will be no further deterioration of the trade account over the program period. I have to say I am somewhat skeptical this can be achieved, given that the economy is expected to grow at over 6 percent a year, and Pakistan's recent track record in this area.

Pakistan's balance of payments outlook will continue to be heavily dependent on capital inflows, which once again underscores the need for airtight policy performance if the staff's "pessimistic" balance of payments scenario is to be avoided. The authorities should also refrain from their past reliance on short-term borrowing, which has fluctuated sharply in recent years, particularly if the commitment to policy reform is going to be similar to the recent past.

On a point related to the devaluation, we do not think that oil prices have been raised sufficiently, as the 7 percent increase only takes into account the October devaluation, and does not account for previous depreciation since January. Full deregulation of oil prices and the sector as a whole is the only effective means to eliminating distortions in this important area. In that regard, could the World Bank representative comment on whether (and if so, when) privatization of the state oil company is envisioned? Indeed, with the exception of Union Bank Limited, the report made little mention of the need for an acceleration of the privatization program. We would expect to see much firmer commitments in this regard in the context of a medium-term program.

Having noted some of our concerns in specific policy areas, there is a broader question of the Fund's role here. What we're looking at is a large up-front disbursement under the stand-by that is paying for what is really a minimal degree of adjustment on the part of the authorities. Indeed, we see little here that goes beyond where the authorities already should have been by now had they stayed on track with their original ESAF/EFF commitments. While I recognize the fragility of the situation in Pakistan, and am willing, though tentatively, to go along with the staff's recommendation to approve the program, I can't help but feel that we're rewarding a country that has made very clear decisions in the recent past to set aside policy commitments to the Fund when the going got tough. This doesn't augur well for being able to negotiate a stronger, more sustainable medium-term program, but I certainly hope to be proven wrong.

Mr. Kiekens made the following statement:

In recent years, Pakistan has represented a standard textbook case of alternation between good and disappointing policies. In 1993/94, tight fiscal and monetary policies, combined with a set of structural reforms in the framework of a comprehensive medium-term program, brought substantial progress in restoring macroeconomic balances. But in 1994/95, relaxation of the adjustment efforts and major deviations from fiscal and monetary programs combined with continued adverse external supply conditions caused the macroeconomic imbalances to reappear. These developments underscore the importance of not relaxing efforts toward macroeconomic adjustment and structural reform.

Mr. Mirakhor's excellent written statement makes it clear how the authorities' efforts to find an easy road to sustainable and non-inflationary growth proved to be in vain. Their reluctance to face up to the necessity for a strenuous fiscal effort have only aggravated their difficulties. A widening trade deficit, declining international reserves and persistent inflation all clearly demonstrate the need for more determined actions directed at the fundamentals of the problems. Especially vital to the long-term restoration of macroeconomic balances are improvement of tax administration and collection, broadening the base of the general sales tax, and substantially reducing tax exemptions and concessions.

I was encouraged to learn that the authorities have recognized the need for an adjustment program with significant structural content and have adopted a stabilization and structural reform package. As confirmed by Mr. Mirakhor's written statement, the authorities have learned from their unsuccessful attempt to postpone the real solutions, and are now committed to a strong package of fiscal consolidation, monetary restraint and structural reforms.

Broadening the tax base and eliminating the extensive exemptions and concessions will be the most challenging aspect of the program, and the authorities must be very firm in these areas. There is some room on the expenditure side for moving resources toward more productive areas. The lowering of defense expenditures by 0.3 percentage points to 5.6 percent of GDP in 1994/95 is a step in this direction, but I believe that the very high level of military expenditures leaves much room for further reductions. I would like to remind the Board that I made a similar observation on the occasion of the last Article IV consultation with India, as there is an apparent correlation between the defense expenditures of these two countries.

Fiscal consolidation should be accompanied by a tight monetary stance on the part of the central bank. Credit and interest rate policies should be geared toward monetary tightening. I therefore welcome the additional information given by the staff at the outset of our meeting, as well as by Mr. Mirakhor's written statement, that the central bank has reinforced its credit control and is moving from direct to indirect instruments of monetary control.

The widening trade deficit and declining international reserves indicate that maintaining Pakistan's external competitiveness will also be crucial to the program. Therefore, I agree with the staff on the need for an exchange rate depreciation. However, I would like to stress that a durable improvement of competitiveness must rely on continuing structural reform and liberalization of the economy, and a lasting reduction of inflation.

Pakistan is receiving an urgently needed credit from the Fund and I can certainly approve such a credit, but only with the clear message that the Pakistan authorities must now deliver and not forego the opportunity to build on their credibility. Pakistan should aspire to a medium term ESAF-supported program, but such concessional support can only be obtained if the present program is fully implemented.

The Deputy Director of the Middle Eastern Department said that he would attempt to address the questions raised by Directors under four broad headings: the fiscal component of the program; balance of payments issues; the design of the program; and World Bank/Fund collaboration.

The fiscal sector was key, because it had been at the center of the deterioration in Pakistan's financial position and was at the center of the program's adjustment and reform effort, the Deputy Director noted. If the required fiscal policies were implemented, there would be an improvement in Pakistan's financial situation, which would allow the other structural reforms implemented over the years to bear fruit more fully.

The program that had been discussed with the authorities included as prior actions a comprehensive set of revenue measures and structural enhancement actions, the Deputy Director stated. The latter actions were important, because the tax system in Pakistan was narrow and inelastic. In addition, significant social spending needed to be undertaken, but expenditures were constrained by the current budgetary situation.

The fiscal adjustment included upfront measures of about 1.1 percent of GDP in gross terms for the remainder of the fiscal year, which amounted to about 1.7 percent of GDP on a full year basis, the Deputy Director commented. If sustained, such a fiscal stance would put the economy on a 4 percent of GDP fiscal track for the rest of 1995/96. That compared with a deficit of almost 6 1/2 percent in the previous year.

Structural fiscal reforms would determine whether or not the adjustment was sustainable, the Deputy Director considered. The immediate emphasis was on full horizontal generalization of the general sales tax. The modification of the law required for that was covered by a structural performance criterion under the stand-by arrangement. There was also a provision for understandings to be reached in the context of the second review for the vertical extension of the general sales tax to the retail and wholesale levels.

The Fund had provided considerable technical assistance in fiscal policy, and there was currently a Fiscal Affairs Department expert stationed in the field, assisting on administrative and other issues, the Deputy Director continued.

The agricultural sector had been outside the tax net until the program supported by the ESAF and the EFF was approved in February 1994, the Deputy Director recalled. That program had included, as a prior action, an initial, albeit modest, inclusion of the agricultural sector within the coverage of the federal budget. The proposed program envisaged a broadening of agricultural taxation through two elements: an increase in the valuation mechanism; and the inclusion of assets that had not previously been covered.

The fiscal measures related to imports contained two elements, the Deputy Director went on. First, the 10 percent regulatory duty, which had the advantage of bringing in revenues quickly and reducing import expenditures, but ran counter to the medium-term structural orientation of Pakistan's reform program. That duty was programmed to be removed by 1996/97, in the context of the next budget. That constituted a performance criterion. Second, the 5 percent minimum import tax would remain in place for two reasons: it removed what had been too broad a range of exemptions and concessions in the import taxation area; and, from an efficiency point of view, it served to reduce tariff dispersion.

The program contained three elements related to tax exemptions and concessions, the Deputy Director added. First, there was a continuous performance criteria that no new exemptions and concessions were to be introduced. As to the recent request the heads of the capital markets had made to the prime minister for certain exemptions, the staff had been contacted immediately, and it had expressed the view that the granting of such a request would be inconsistent with the program. The program also specified the removal by end-January of a specific exemption that constituted a significant loop hole in the system, namely, the exemption for special industrial zones. And, finally, as part of the first review, understandings were to be reached on the phasing-out of other exemptions and concessions.

The staff would agree with the comments put forward by Mr. Kiekens and Mr. Schoenberg on unproductive expenditures, the Deputy Director of the Middle Eastern Department said. Military expenditure as a proportion of GDP had amounted to 6.5 percent in 1992/93. It was currently budgeted at 5.3 percent of GDP. Moreover, the authorities had made commitments over a three-year period to further reduce the ratio of military spending to GDP, taking into account security considerations. The World Bank staff had been working closely with the authorities on the Social Action Program, core investment outlays, and, more generally, the public sector development program.

Mr. Newman commented that a comparison of the post-budget measures with the outcome in 1994/95 might overstate the extent of the measures that had been put in place. The tables in the staff report seemed to indicate that the budget outcome--absent the measures taken in October and November--for 1995 would have been 5.2 percent of GDP, and that, because of those measures, the overall outcome would be 4.6 percent of GDP. However, much of the improvement in the overall outcome was attributable to the income effects of the growth rate. The measures themselves actually accounted for only about 0.6 percent of GDP.

The Deputy Director of the Middle Eastern Department said that the authorities had implemented measures that would yield, on a gross basis, 1.1 percent of GDP for the remainder of the fiscal year. Given the deterioration that had taken place in the first four months of the year, the fiscal outcome for the year as a whole would amount to 4.6 percent of GDP. It would be difficult to assess what the outcome would have been in the absence of the measures taken in October and November 1995. Initially, the authorities had aimed for a budget deficit of 5 percent of GDP. The staff had expressed two very strong concerns at that time. First, the target of 5 percent, per se, was not adequate given the challenges that Pakistan faced; second, the measures in place would not have achieved the 5 percent target. The staff had estimated a deficit of 5.2 percent of GDP prior to the deterioration in the first four months of the fiscal year.

As to capital flows, and in particular foreign direct investment and portfolio investment, the experience since June was illustrative, the Deputy Director considered. Portfolio flows had proved to be very sensitive to the change in risk perceptions. Foreign direct investment proved to be less sensitive, reflecting among other things, the large energy component connected with the new program. Looking forward, foreign direct investment inflows would be governed by the energy program. And they would have their counterpart in imports. Portfolio flows would remain vulnerable. Indeed, Pakistan was an example of a market that had become integrated into the international capital market system. The staff had not made any allowances in the projections for additional external privatization proceeds. The understanding with the authorities, as reflected in the program, was that--

to the extent that such proceeds materialized--they would be added to reserves.

The accelerated timetable for bringing the proposed stand-by arrangement to the Board reflected the need to move rapidly at a time when there was a very large loss of reserves, foreign currency deposits were starting to be withdrawn, large debt payments were coming up, and there was a significant requirement for rollover of credit facilities, the Deputy Director commented. The data were illustrative in that regard. Reserves were down almost $1 billion, to six week of imports, which was not a comfortable level by any standard, and at a time when foreign currency deposits amounted to $6 billion. There was a need to move quickly and to try to build on the authorities' measures to turn market sentiment around before it was too late. Of course, progress would depend critically on sustained policy actions.

Approval of the authorities' request for a stand-by arrangement would have two important effects, the Deputy Director considered. First, it would send a clear signal--and Pakistan's markets understood such signals--that the Fund endorsed the adjustment and reform measures. Second, it would help to bolster gross reserves at a time when there was a need to rollover credit lines and to calm markets. That had also been a determining factor in setting the phasing of the purchases under the program.

The program was accompanied by a frontloading of measures and significant prior actions, including several revenue measures, the Deputy Director noted. It should be stressed that the provisions also included close monitoring. There were three program reviews, one was to be conducted by March 1996, which meant that the staff would be back in Pakistan in January; and a second one was to be conducted by June 1996. The program also had a relatively comprehensive set of quantitative and structural performance criteria. Moreover, as noted in the staff paper, the performance criteria related to the budget had been upgraded. Progress would also be helped by the extensive technical assistance program that the Fund was providing.

Looking forward, it was important to recognize that the authorities did not view the stand-by arrangement as the end of the process, the Deputy Director said. Recent events had demonstrated that a long-term relationship with the Fund had merit, and the authorities were eager to move back to a multiyear arrangement, in particular because of the policy framework such arrangements provided. It would also facilitate their interactions with other creditors and donors, as well as the markets.

The Fund staff was maintaining close collaboration with the World Bank on Pakistan, the Deputy Director stated. The close contacts between the Fund and Bank staffs at headquarters were helped by close contacts between the World Bank and the Fund's resident representatives in the field. The World Bank staff had participated in discussions between the Fund staff and the authorities and in Fund missions. Finally, the Fund staff looked to the

World Bank for inputs on structural measures that were directly reflected in the program, particularly with respect to the Social Action Program, the Core Investment Program, and the privatization program.

The staff representative from the Middle Eastern Department noted that the ceilings on banks' lending rates had been removed in early 1995. Following the increase in the minimum lending rate on all concessional credit to 14 percent, all banks' lending rates had become positive in real terms.

The retail prices for petroleum products had been raised by 7 percent in late-October 1995, the staff representative said. That was in addition to the 6 percent increase in petroleum product prices that had come into effect in July 1995. Thus, the staff's revenue estimates were based on this and the price of $17 a barrel included in the budget for imports. Government revenues from the oil and gas surcharge had remained at about 1 percent of GDP for the past several years, and they were expected to remain at about that level for 1995/96. It should be noted that, although the recent increases in petroleum product prices were intended primarily to offset the impact of the devaluation, they were expected to yield more than PRs 4 billion on an annualized basis.

Pakistan had made significant progress in opening the energy sector to private investment over the past several years, the staff representative commented. A private undertaking to open a refinery in Karachi by private investment was currently under way. One of the main gas fields in Pakistan had already been privatized, and the authorities had added two others to the list of entities to be privatized. In addition, the government had announced that it would be interested in selling 49 percent of the shares in the state oil company, which was being corporatized, to private investors.

Mr. Schoenberg noted that the background paper circulated to Directors on December 8, 1996 indicated that the rate of return on bank deposits was significantly below the rate of inflation, with detrimental consequences for financial intermediation. That paper also indicated that, given the prevailing rate of inflation of about 13 percent, average money market rates were negative in real terms. He wondered whether the staff could comment on whether interest rates were still negative in important segments of the financial system.

The staff representative from the Middle Eastern Department responded that deposit rates were still negative in real terms, and the treasury bill rate, which was about 12.75 percent, was close to the rate of inflation.

The Deputy Director of the Policy Development and Review Department stated that the question of whether to put in place a Fund-monitored program or a stand-by arrangement was always a matter of judgment. As Directors had indicated, Pakistan's recent track record made that question difficult. Nevertheless, the authorities had demonstrated their commitment to the new program by putting in place substantial up-front measures in both the fiscal and monetary areas.

The pattern of disbursements envisaged under the proposed stand-by arrangement for Pakistan was like those contained in similar arrangements for other countries--excluding the programs recently undertaken by Argentina, Mexico, the Russian Federation, and other countries of the former Soviet Union, the Deputy Director of the Policy Development and Review Department stated. The proposed arrangement for Pakistan provided for more frequent reviews, and it included more structural performance criteria. In that respect, the drawings under the stand-by arrangement for Pakistan--beyond the first--were well safeguarded.

Mr. Shields commented that the case of Pakistan was unique in that the program supported by the ESAF and the EFF had recently gone off track. It was somewhat unusual for countries to bring requests for stand-by arrangements to the Board so soon after a previous program had gone off track.

Mr. Newman noted that the drawings--beyond the first--under the proposed stand-by arrangement seemed to replace those forgone under the program supported by the ESAF and the EFF, which had gone off track.

The Deputy Director of the Policy Development and Review Department stated that, in coming to a judgment on Pakistan's request for a stand-by arrangement, it would be important to consider both the strength of the proposed program and the balance of payments need.

The pattern of disbursements under the proposed stand-by arrangement was designed to ensure an even distribution of drawings following the initial disbursement; any similarity between that pattern and the previous enhanced structural adjustment and extended arrangements was coincidental, the Deputy Director of the Policy Development and Review Department said.

Mr. Havrylyshyn made the following statement:

> I will focus on an issue that most, if not all, previous speakers have mentioned, namely, Pakistan's past record of performance, and how it might affect the proposed program.
>
> The historical background consists primarily of some successful adjustment in 1993/94, followed by substantial slippages that led eventually to the current situation, which calls for urgent action.
>
> Although it is the need for urgent action that is currently under consideration, it is important to note what Mr. Mirakhor has referred to as the credibility problem stemming from the previous performance of Pakistan. To overcome this credibility problem, it was clearly necessary to have strong prior actions. In light of

the substantial prior actions that have been taken, which strengthen the authorities' request for a stand-by arrangement, I can support the proposed decision. Although I welcome these initiatives, including the strong prior actions and the efforts aimed at fiscal consolidation and monetary tightening, as well as the 7 percent devaluation of the exchange rate, Pakistan's past record does cast a shadow over our deliberations and leaves open some very important questions.

Perhaps the most important question is whether the impressive package of prior actions and the planned program is enough to rebuild the authorities' credibility. This is clearly the most important task facing the authorities, and they must avoid any slippages from the envisaged program of financial policies and structural reforms. A second important task is to take the very earliest possible opportunity to go beyond the programmed actions, particularly in the area of budgetary reform, along the lines suggested by Mr. Newman.

My position is similar to that of many previous speakers. Although the proposed program goes in the right direction, there is some question about whether it goes far enough. In that respect, the current situation of Pakistan could be likened to a visit to a dentist: it highlights the difficulties of living with the consequences of your past errors and the pain that this causes. Although the dentist will do what is urgently necessary on the first visit, he may need to follow up by saying, "This is not going to be enough. You are going to have to work a lot harder in the future."

Mr. Fayolle made the following statement:

First of all, I would like to commend the staff for this very candid set of papers, which does not underestimate the potential difficulties in the implementation of the proposed program.

I will limit my comments to the following remarks.

The current evolution is, as it appears very clearly in Table 6 of the report, cause for concern: considering the situation at the end of the first semester, I have serious doubts that in the area of trade account, current account the fully justified measures adopted by the authorities at the end of October will have an impact strong enough for Pakistan to achieve its quantitative objectives for the whole fiscal year.

I will therefore stress the need for the authorities to strictly adhere to the program which is clearly a minimum. Actually, the number of uncertainties remain high and the authorities are facing important challenges:

The improvement in the fiscal area relies in particular on the new 10 percent import surcharge. I agree with the staff that this measure is regrettable and has to be considered as temporary. But the elimination of this measure supposes an increase of other taxes and extension of the general sales tax. Therefore the resolve of the authorities to overcome major opposition. The authorities have to decide very quickly specific measures to phase out the tax exemptions and concessions. The letter of intent refers to an "understanding to be reached on a plan for phasing out tax exemptions by end-March 96." I understand this as meaning that there is an agreement on a specified, scheduled and quantified plan.

The evolution of inflation is also a matter of concern, especially if one takes into consideration the slippages which occurred in year 1994/95. I would like the staff to indicate what could be the consequence of last month devaluation of the Pakistan currency on the level of inflation for the year 1995/96, and how high is the risk to create a devaluation/inflation spiral.

To summarize, the strict implementation of the proposed program appears absolutely crucial in order to begin the process of improving confidence in the Pakistan economy. This is why I can support the proposed decision. But at the same time, like previous speakers, I would like to underline very clearly that it is, from the point of view of my authorities, premature to speak now on a possible extended arrangement for Pakistan and even more of an ESAF. There must be no ambiguity that we expect a 100 percent or more compliance with all agreed measures.

Ms. Bessone Basto made the following statement:

The recent emergence of macroeconomic imbalances mainly as a consequence of loose financial policies demonstrates the need for the Pakistan government to undertake a serious adjustment and reform effort as soon as possible. The stabilization measures implemented in October and November are essential to reduce these imbalances, and are indicative of the government's willingness to regain control of macroeconomic management. We can therefore, support their request for a stand-by arrangement, necessary to pave the way for a comprehensive medium-term program, even though, in order to be on the safe side, we would have welcomed a slightly stronger program. Given that previous speakers have already covered most issues, I will limit myself to only a few remarks.

We cannot fully share the optimism of the staff report, in particular, concerning the country's ability to achieve a GDP growth of 5.5 percent in 1996 and 6.5 percent in 1997. Indeed, this is hardly compatible with the tighter fiscal and monetary conditions envisaged in the program, and in the absence of a significant increase in the savings/GDP ratio. We also wonder whether the expected increase of the export/GDP ratio by 2 percentage points over the next two years following the 7 percent devaluation is realistic, given the forecast deceleration of import volume growth of the trading partners, as shown in the table 6 of the staff document (EBS\95\208).

Our primary area of concern about the program for 1995/96 lies in the fiscal consolidation effort, which is considered to be the cornerstone of the adjustment strategy. First, we wonder whether this effort is sufficient, as the program envisages only a small deficit reduction in 1995/96 (0.9 percent of GDP) and an even smaller one in the subsequent year (0.6 percent of GDP). Second, we are concerned by the way this effort is being undertaken, as the measures implemented so far involve a perhaps excessive reliance on import duties and only modest expenditure cuts.

Despite these limitations, the structural fiscal measures envisaged in the 1995/96 program are most welcome. The broadening of the general sales tax and the phasing-out of tax exemptions and concessions, in particular, are required in order to allow a much-needed tariff reform and compensate for its negative effect on the budget. We hope that with Fund technical assistance in this area the authorities will successfully overcome administrative hurdles that, according to Mr. Mirakhor, have undermined the past implementation of these measures.

Mr. Fukushima made the following statement:

As Mr. Mirakhor's informative statement mentions, the authorities' efforts toward sustainable growth under the ESAF and EFF programs were again hampered by continuing poor weather conditions and crop disease. Regrettably, this has resulted in the cancellation of the ESAF and EFF arrangements and I would urge that the 1995/96 reform package which the authorities initiated this fall be implemented in cooperation with the Fund.

As I share the staff's views, I will make just few comments for emphasis.

On fiscal policy, it is welcome that the fiscal position has been strengthened by broadening the base of the general sales tax. However, I am concerned about the unidentified expenditure. Efforts should be made not only toward strengthening fiscal revenue but also toward modernizing the accounting system. I would like to recommend Fund technical assistance in this area.

Concerning external policy, it is a concern that the authorities have uncovered short-term foreign currency liabilities. This situation should be remedied as soon as possible before any losses arise as a result of the potential exchange rate risk.

It is welcome that the authorities are addressing tariff reform. However, as Mr. Shaalan says in his statement, a too-ambitious tariff reduction should be avoided. Also, there is currently too much emphasis on import tariffs. This distorts the tariff system and should be remedied as soon as possible. Tariff reduction should be linked to and supported by the strengthening of domestic tax revenue, the maintenance of a flexible exchange rate system and an improvement in international competitiveness through structural reforms.

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

Mr. Song made the following statement:

Tremendous efforts have been made by Pakistan's authorities in pursuing macroeconomic stability and structural reform under the difficult circumstances of the past two years. The Fund stand-by arrangement and ESAF/EFF resources support had helped along the progress in increasing international reserves and decreasing inflation in 1993/94. However, later developments in monetary expansion, trade, and fiscal account imbalances, mainly due to adverse weather conditions and crop disease in the agricultural sector, demonstrate that further and continued endeavors are highly warranted.

I am in general agreement with the staff on the main thrust of the papers and am convinced by Mr. Mirakhor's buff statement that the request for a stand-by arrangement before the Board today justifies itself by aiming to reverse the trend of international reserves, and achieve overall price stability and substantive fiscal consolidation. And it is my belief that macroeconomic stability and external viability are indispensable for sustained economic growth. Therefore, I support the proposed decision contained in EBS/95/208 page 22 and would like to make some comments for emphasis on the fiscal and monetary policies.

Fiscal reform has been a key factor influencing the course of economic development, and it is encouraging to see that particular attention has been placed on fiscal policy, and that the fiscal deficit is expected to decline by a large margin in accordance with the new program. In this connection, the expansion of the domestic tax base and elimination of regulatory tax exemptions will greatly enhance the revenue buoyancy of the tax system and create conditions necessary for an improvement in tax administration. I believe that the broadening of the general sales tax base and removal of all general and specific exemptions will be effective measures to mobilize fiscal revenue.

While an indirect monetary instrument is being activated, the monetary policy will heavily rely on the attainability of growth targets for the monetary aggregates. Given the authorities' determination to curtail the budget deficit, therefore, the borrowing requirement over the banking sector and credit advances from the State Bank of Pakistan to commercial banks will have critical roles to play. In this regard, practical strategies for enhancing the efficiency of state banks and reforming the banking sector would direct the program toward a medium-term arrangement. I agree with the authorities' intention to make the current stand-by arrangement a preparatory phase for a substantial structural adjustment process. As a short term remedy, in my view, the credit ceilings set by the State Bank of Pakistan over borrowing from the public sector and autonomous bodies could be very effective instruments for the monetary policy.

I commend the authorities for their resolve in eliminating the remaining exchange restrictions and multiple currency practice to accept the Article VIII obligations in July, 1994 and their achievements in advancing structural reform measures. I wish them success in the implementation of the ambitious policy measures under the program supported by the stand-by arrangement.

Mr. O'Loghlin made the following statement:

This chair is disposed to support the proposed stand-by arrangement for Pakistan.

We recognize that developments over which the Authorities had little or no control (ranging from adverse weather to crop disease to civil unrest) contributed in some measure at least to the failure to meet the full range of performance criteria under the February 1994 ESAF/EFF arrangements; and that there was substantial adjustment effort under those arrangements, notwithstanding that several of the agreed measures were not implemented. We also note that the amount of the proposed stand-by arrangement is less than the undisbursed element of funding which had been provided for under those arrangements--which are now to be canceled.

However, our support is not without misgivings.

Past performance does not instil optimism that there is now commitment to adjust and reform sufficiently to set the economy on a sustainable growth path--which is the ultimate rationale for providing the stand-by arrangement. The Authorities' resolve when adopting the initial ESAF program early in 1994 clearly weakened within months. The understanding which they developed with the staff in April 1995, aimed at bringing the ESAF back on track, vanished within weeks. The timing of the present request--coincident with weakening of Pakistan's international reserves--also raises doubts about the degree of commitment to reform. Reassurance on this score, if it can be given, would be helpful today. More important, in light of the Authorities' wish that this arrangement should be "a stepping-stone to a medium-term program," any loss of resolve during this stand-by arrangement--if approved--would raise major questions over the matter of a successor program.

It appears that, under the stand-by arrangement proposed, the matter of removing those of the numerous tax exemptions and concessions which are not time-bounded is being somewhat long-fingered--the goal being to reach an understanding with staff by end-March on a schedule for their elimination starting in 1996/97. There is a pragmatic, and understandable, reliance on increased import taxes to act on the budgetary deficit in the short term. This, like the recent expansion of exemptions and concessions, runs counter to the thrust of policy envisaged under the ESAF. It is to be hoped that the end-March schedule, when finalized, will incorporate a fair degree of frontloading. That would give positive signals to markets about the quality of the Authorities' intentions and would usefully underpin the necessary retrenchment effort.

A further concern, but more in relation to Fund policy than to Pakistan, is with the possible impact of arrangements of the nature proposed here on the potential effectiveness of ESAF arrangements in general. In financing terms, the SDR 402 million to be provided under the proposed stand-by arrangement substantially substitutes the undrawn balances, amounting to SDR 660 million of the canceled enhanced structural adjustment and extended arrangements. Is there a risk, if stand-by arrangements are made available quickly after enhanced structural adjustment and extended arrangements have gone off track, that the incentive to keep to the agreed parameters of the latter programs will be eroded, and their potential effectiveness thus undermined?

In conclusion, this chair wishes the authorities well in the endeavor upon which they are embarked and, as I have indicated, supports the proposed stand-by arrangement.

Mrs. Cheong made the following statement:

First, I would like to comment on Mr. Schoenberg's remarks about developments in Pakistan since 1980 and Mr. Mirakhor's explanation of Pakistan's reform efforts since 1988. In undertaking reforms since 1988, Pakistan would be joining the other countries in the region. Broad winds of change sweeping the South and Southeast Asian regions occurred only after the mid-1980s. The period before 1985 was, in a sense, inconsequential because few measures were implemented during those years, even among Southeast Asian countries. However, the important difference between Pakistan and the Southeast Asian countries that undertook reforms in the 1980s was that the latter accompanied their reform efforts with severe fiscal tightening. Although it is easier to depend more heavily on monetary policy, it is fiscal discipline that will ensure long-term macroeconomic growth. The fiscal tightening measures is the key to success, something that Pakistan should note.

Pakistan has indeed slackened in its monetary and fiscal adjustment; but the issue before us is whether the Fund should step backwards when countries fall short in their reform efforts, especially for an important and a big country like Pakistan. I believe, that in evaluating a request for assistance, we should give cognizance to the favorable developments in the applicant country in a balanced manner as we do for the authorities' shortcomings. As Mr. Shields has pointed out, it is our role to bring countries back on track, especially when it is willing to accept a strong Fund program. We should respond positively to assist such a country. The Fund can only be effective from within, owing to the conditional character of its lending.

Front loading of the program for Pakistan appears not to be any different from practices for other countries as explained by the staff. Like other countries, prior actions were also required.

Mr. Newman correctly mentions that it is the markets that are pushing countries to accelerate reforms. Our experience in the Indochinese and Southeast Asian states prove that this pressure can indeed be very "over-bearing" and countries are not likely able to go against the tide. The only issue is whether they can undertake reforms with or without Fund assistance. Pakistan obviously is in the former category. It would then be shameful if the Fund does not render support, because Fund assistance at this stage can impose the necessary macroeconomic adjustment so that Pakistan will have the economic foundation to take advantages of the linkages arising from the economic liberalization measures sweeping the region, especially in countries like India.

Finally, on military expenditure, I am one of those who favor reduction of this expenditure. However, I feel that we should be evenhanded in treatment of program countries. In this regard I recall that the same concerns were raised in the case of Russia. Treatment of Pakistan in this area should also be similar.

With these comments, I support the proposed decision.

Mr. Jones made the following statement:

The program represents a major step toward reducing the macroeconomic imbalances in Pakistan's economy. I believe the authorities recognize this as such, having expressed intention to strengthen their adjustment and reform effort in the context of a medium-term framework that could be supported by the Fund. Meanwhile, Mr. Mirakhor has assured the Board of the authorities' commitment to stay the course with the new program, being convinced that there is no easy road to achieving sustained growth and macroeconomic stability. I can, therefore, support the request for a stand-by arrangement.

The Deputy Director of the Middle Eastern Department noted that the exchange rate devaluation and the import-related fiscal measures, namely, the 5 percent minimum import duty and the 10 percent regulatory duty, were expected to have a combined impact of about 1.5 percentage points on the consumer price index. The tightening of fiscal and credit policies would be critical in avoiding a spiral effect on inflation and in overcoming the current fragility of the financial position.

The Deputy Director of the Policy Development and Review Department said that the program to be supported by the proposed stand-by arrangement was much stronger than the previous program supported by the ESAF and the EFF; the authorities had taken a number of difficult prior actions; and financing under the stand-by arrangement was far more expensive than that under the ESAF. Therefore, the stand-by arrangement should not be regarded as "an easy way out" of the failed ESAF-supported program.

Mr. Mirakhor thanked Directors for their comments. He was especially grateful to Mrs. Cheong for her supportive remarks about the situation currently confronting the Pakistan authorities.

As the staff had responded effectively to all of the questions and comments raised by Directors, in particular those regarding the incentives for the authorities to ensure the program's full and timely implementation, he could limit his remarks at the present stage, Mr. Mirakhor said. He would convey to his Pakistan authorities the essence of the current discussion, which had focused on the need for Pakistan to regard the measures contained in the stand-by arrangement as a minimum and to strengthen the past record of policy implementation.

The Acting Chairman made the following summing up:

Executive Directors regretted that Pakistan's adjustment and reform effort had faltered. As a result of the weakening in fiscal and monetary performance and the slackening in the process of structural reform, Pakistan is again facing a difficult situation with a widening of macroeconomic imbalances, a large trade deficit, and the steady loss of international reserves.

Directors were encouraged by the reinvigoration of the authorities' efforts, and noted that it was essential that the new economic program be rigorously implemented in order to achieve its objectives and rapidly re-establish confidence. While a number of Directors felt that Pakistan's new policy program was not strong enough on fundamental reforms, all speakers stressed the importance of full and sustained implementation, and urged the authorities to take additional corrective actions to ensure achievement of the program objectives. The challenges facing Pakistan require steadfast policy implementation. Given the large volume of short-term external debt and the low level of international reserves, there was no scope for policy slippages. Solid implementation of the new program was essential to improve Pakistan's track record and to lay the foundation for a medium-term program that could be the basis for a new multi-year Fund arrangement.

Directors noted that the prior actions incorporated fiscal, monetary, and exchange rate measures, and that there was a substantial structural component in the adjustment program. Fiscal consolidation was a cornerstone of the adjustment program. Noting the initial fiscal adjustment relied on the expedient of an increase in the import regulatory duty, Directors stressed that a key element of the overall reform would be the removal of the regulatory duty and a reduction of the tariff rates, and they urged the authorities to advance the agenda for tariff reform.

Structural reforms to improve the budget also needed to be vigorously implemented. Directors placed strong emphasis on extending the general sales tax, broadening agricultural taxation, and phasing out exemptions and concessions. They also welcomed the introduction of an automatic mechanism for adjusting retail petroleum prices, noting that this would protect budgetary revenue and promote efficiency. Directors noted that it was imperative to reform the federal-provincial revenue sharing arrangement so as to ensure the integrity of the fiscal targets.

Directors underscored the need to control government expenditure and improve its efficiency and composition. They called for greater efforts to reduce unproductive spending, including military expenditures--which some regarded as high--and to increase developmental outlays, particularly given the importance of full and sustained implementation of the Social Action Program and the Core Investment Program. Directors emphasized that privatization proceeds should not be used to finance unsustainable increases in government expenditure. The critical importance for Pakistan to improve the transparency of its budget management was also emphasized.

Directors stressed that the programmed strengthening of the fiscal accounts, the reduction in government-directed credit, and the containment of credit to the public enterprises constituted key elements for bringing down monetary growth substantially during the remainder of 1995/96. They pointed out that these efforts needed to be fully supported by an intensified use of indirect monetary instruments, especially moving toward positive real interest rates. In this context, they welcomed the recent elimination of the credit-to-deposit ratio mechanism as well as the earlier removal of the ceiling on the rates of return. In the view of Directors, the authorities should accelerate their efforts to phase out mandatory and concessional credit schemes and to strengthen bank regulation and supervision. Moreover, they should proceed with the privatization of the remaining nationalized banks.

Most Directors emphasized that flexible management of the exchange rate was appropriate. In this context, Directors stressed that it was imperative that exchange rate policy be fully supported by restraint in fiscal and monetary policies to contain inflation and preserve competitiveness. The importance of the improved international market access for Pakistan's exports was also noted.

In conclusion, it is very important to note the observation made by several Directors that, in the context of today's globalized financial system, the markets are holding countries to higher, more demanding standards than before. Pakistan's recent experience is instructive and illustrative of the financial markets' strong and swift reaction to the faltering of authorities' adjustment and reform policies. Pakistan's balance of payments is heavily dependent on capital inflows. Thus, it will be essential that Pakistan establish a strong track record of fundamental and sustained adjustment and reform in order to restore and maintain the confidence of the markets and of the international community. The present program is a first step in that direction.

It is recommended that the next Article IV consultation with Pakistan be held on the standard 12-month cycle.

The Executive Board took the following decision:

1. The Government of Pakistan has requested a 15-month stand-by arrangement in an amount equivalent to SDR 401.85 million.

2. The Fund approves the stand-by arrangement set forth in EBS/95/208, Supplement 1.

3. The Fund notes the cancellation on December 4, 1995 of the arrangement under the enhanced structural adjustment facility and the extended arrangement approved by the Fund on February 22, 1994 (EBS/94/9, Sup. 2).

Decision No. 11141-(95/118), adopted
December 13, 1995

2. ADMINISTRATIVE AND CAPITAL BUDGETS - MEDIUM-TERM OUTLOOK

The Executive Directors considered the Managing Director's memorandum on the budgetary outlook in the medium term (EBAP/95/100, 11/29/95; and Sup. 1, 12/12/95), as well as his memorandum on the midyear review of the Fund's administrative and capital expenses. They also had before them a background paper on activities and resource utilization in financial years 1997-99.

Mrs. Cheong made the following statement:

Let me at the outset express my appreciation for the management's budgetary discipline in curtailing actual spending during the first half of financial year 1996 in order to keep the total spending for the whole of financial year 1996 within the approved budget. As the Managing Director noted in his memorandum, there may be a need to postpone more projects to achieve the budgetary objectives of the Fund. While the desire to ensure budgetary discipline is commendable, I believe we need to step back for a moment to consider the objectives and implications of budget cuts. This is to ensure that budgetary consolidation is implemented with the proper perspective, instead of being done just for the sake of fiscal discipline. In this regard, I share Mr. Shaalan's concern that the 1996 budget could be overly stringent. There could also be a trade-off between over-zealousness in trying to be a lean organization vis-a-vis the Fund's effectiveness in pursuing its primary objectives.

I agree with the Managing Director on the appropriateness of the strategy for continued budgetary consolidation as described in the Managing Director's proposal for the medium-term. However, I have some reservations on the method of undertaking this consolidation. In the context of the post-Mexico period of strengthened surveillance and the emphasis for members to provide timely data, the demand on Fund resources is likely to increase significantly, on top of the anticipated demands from post-conflict countries. Under these circumstances, I doubt whether there is still room for further tightening without compromising this institution's primary objectives. As I see it, the Managing

Director's strategy of the medium-term budget outlook seems to be rather "supply-determined" which is based on an across-the-board zero-growth target of staff resources for financial years 1997-99. Each department, then, derives its work program based on this target. From the background material of EBAP/95/101, we note that each department is contemplating the redeployment of available resources to achieve the department goals. In general, there seems limited room, if any, for further manoeuvre. The work program needs to be streamlined by reducing or eliminating low-priority activities and focus more on "core" activities. In some cases, consolidation may inevitably entail cutbacks of some core activities.

In the Southeast Asia and Pacific Department, for example, the resource constraint is now particularly tight. In a scenario of unchanged resources amidst greater demands on surveillance of emerging markets, fewer resources will be available for country-specific work, including the support for the provision of technical assistance. Mission activity to a selected number of potential program countries may have to be curtailed. Time spent on producing country-specific analytical papers will be tightly constrained. Other "non-core" activities, such as participating in technical assistance missions, policy development, and evaluation and research may have to be reduced or eliminated.

In the Central Asia Department, demand for staff resources will increase in financial year 1997, in line with an increasing number of countries under adjustment programs and strengthened surveillance on large Article-IV countries such as Japan, China, India and Korea. Under the unchanged resources strategy, it will be difficult to maintain the usual high quality work standard and the increased workload pressure may inevitably translate into increasing unpaid overtime, leave foregone and excess travel. Less time will be spent on non-core activities and for supporting technical assistance.

The increased Fund workload is also reflected in the more intensive Board meeting agenda, which arises from our efforts to strengthen surveillance. In this scenario, more demands will also be made on staff time, leaving limited time to broaden their knowledge outside the subject-related papers. In this regard, I share Mr. Shaalan's concern on the erosion of our intellectual capital.

While I concur with the Managing Director's view to better prioritize the Fund's activities and eliminate low priority activities, the efforts should not be at the expense of undermining the Fund's capacity to respond effectively to the increasing demands. This chair maintains that a more comprehensive approach would be to evaluate the demands on the

Fund's resources and then prioritize these demands. To ensure that the overall budget should not be increased, options on the activities to be scaled down or eliminated altogether should be presented to the Board. This bottom-up approach would provide a better opportunity to decide on priority and non priority areas. In the event that maintaining priority areas entails an increase in the budget, the choice will be more apparent--either some cuts in priority activities or an increase in the overall budget. This is a more transparent approach and will better assist the Board in setting priorities.

On the issue of priorities, I am particularly concerned with the proposed trend in the provision of technical assistance for financial years 1997-99, as shown in Table 4 of EBAP/95/100. While I support the Managing Director's proposal to accord top priority to the work on technical assistance, I wonder if his view is adequately reflected in the proposed scenario of the unchanged internal resources devoted to technical assistance for financial years 1997-99. The scenario casts doubt on the Fund's ability to satisfactorily accommodate the rapidly growing demands. In the work program of the Monetary and Exchange Affairs Department, for example, the use of staff resources for technical assistance for financial years 1997-99 is set to decline. Demand for technical assistance from member countries will continue to increase, especially since more countries are under Fund programs. The department will inevitably be required to exercise greater selectivity in reviewing technical assistance requests.

It is proven that education through technical assistance is one of the Fund's greatest contributions to economic stability and growth in developing countries. Faithful compliance to sound macroeconomic policies, especially in emerging economies, are the results of the education process from their own resources and enhanced by more specific technical assistance from the Fund. In the long-run, technical assistance has more sustainable benefits than even direct financing. This chair views strongly that a medium-term decline in resources devoted to this area will significantly undermine the efficacy of the Fund's lending programs. Currently, we see more demands for technical assistance by program countries. Even in non program countries, especially the emerging markets of SEA, Fund technical assistance is being sought to assist in improving monetary management and payments systems to ensure that they are sufficiently dynamic to cope with the globalization of financial markets. These countries are also moving rapidly to develop more sophisticated money and capital markets and Fund technical assistance is viewed as a vital prerequisite.

In this perspective, I view that the Fund's budgetary consolidation strategy has a costly trade-off. On the one hand, In this perspective, I view that the Fund's budgetary consolidation strategy has a costly trade-off. On the one hand, the Fund aims to strengthen the data publication standards and improve the provision of economic and financial data to the Fund for surveillance; on the other hand, it scales back the provision of technical assistance which is essential to develop better data and promote sound policies. If the issue is insufficient staff resources, I would support a broader scope for elimination of certain non core Fund's activities which are of lower priority.

While I appreciate the suggestion to charge recipient member countries for technical assistance expenses, this can only be effected after careful thought. Not all members can afford the high costs of engaging foreign consultants. This aside, in principle, technical assistance is a primary core function of the Fund. Payment for this service would be inconsistent with the spirit of the Fund's objectives as technical assistance is an important vehicle in the exercise of the Fund's functions to achieve its objectives. A requirement to pay for technical assistance may force the poorer member countries to delay their efforts to improve data and undermine the Fund's objective of strengthening surveillance.

In closing, while I can support any effort to explore all budgetary options and to redeploy staff resources toward priority activities in order to improve productivity, a more comprehensive assessment of overall Fund activities and functions may be needed. In this regard, a bottom-up approach based on itemized budget estimates would improve transparency and better assist the Board in setting priorities.

Mr. Mohammed, speaking on behalf of Mr. Shaalan, made the following statement:

Undoubtedly, the substantial growth in the staff in the early 1990s was necessary not only to accommodate the demands of both the increasing membership and the new demands on the institution but also to reduce the imbalances resulting from the increased workload of the 1980s. The December 1993 budget proposal which called for budgetary consolidation in the three fiscal years 1995-97 was probably appropriate at the time the decision was made. In the mid-term budget discussion a year ago, before the Mexican crisis, the Managing Director suggested that in the absence of unanticipated demands, the policy of budget consolidation could be tightened further. Opinions in the Board then were divided--some Directors endorsed the position, others were prepared to support an even more stringent budget, while yet others were concerned that the Managing Director's proposal was so stringent that it could be counterproductive. I was one of those who strongly held the latter view. It should also be noted that increasing number of Directors voiced the view that the budget was overly stringent.

Today, I am convinced, in view of the recent workload developments, which are so aptly described in the Managing Director's statement, that we have reached a point where we need to step back and make a comprehensive assessment that would look beyond budget consolidation per se and give serious consideration to other factors that are equally, if not more, important than just dollar costs. If we are to continue to be effective in addressing the demands and needs of the membership in a high-quality and timely manner, be mindful that the impact of the increased workload does not place unreasonable demands on the staff, and accord high priority to preserving the rich human capital that we have, I am concerned that the Managing Director's proposal does not meet these objectives.

First, work activity as depicted in Table 3, while showing some increase, in no way captures the full story. Let me elaborate. While the table shows what has been, or will be, done over the period covered, it, of course, cannot show what needed to be done but was postponed due to staff constraints. Delays in responding to members' legitimate requests for technical assistance in an increasingly complex global economic environment is very evident, not only in my constituency, but Fund-wide. I understand that one major department providing technical assistance is not accepting requests for the last four months of the fiscal year on account of resource shortages. This situation is far from satisfactory. Also, the table does not, and of course cannot be expected to, include the staff requirements to address new or increased activity associated with surveillance, monitoring through more frequent staff visits, provision of statistics, etc. Take, for instance, the Middle Eastern Department budget statement where it is clearly stated that consultations with four countries--fully more than 15 percent of the countries serviced by the department--would have to be postponed to financial year 1998, owing to staff constraints. This is not reflected in the activity table.

Second, on the overstretched staff, I would have liked the report to include indicators of the sustainability of the current workload. These would cover underutilization of leave, the rise in travel by a growing number of staff members over the guidelines--this cannot be read from Appendix 8 since the number of travel days may be carried out by a smaller number of staff--and unpaid overtime. In this latter connection, we have been told that the work week consists of 40 hours. I can appreciate that at times of peak workloads the staff may be expected to put in 50 or 60 hours a week. But when even more than that is a steady diet for the more senior staff, particularly of area departments, it cannot by any stretch of the imagination be considered acceptable. I would like to see a detailed table showing the length of the work week by staff grade and department. We need to attach significantly more importance than has been the case to these indicators. I would agree with the Managing Director when he refers to the strong pressures on the staff. Budgetary consolidation can well be self-defeating if viewed in isolation of the adverse impact on the staff--to which we seem to be according a zero-dollar value.

Third, the intellectual capital--the Fund's most important asset--needs to be addressed in our budget deliberations. Regretfully, we have only paid lip service to this aspect but have done very little about it. I would like to bring to the Board's attention some areas on which I have had extensive discussions with the staff. A surprisingly large number of staff members unfortunately not only do not have the time to read important policy papers but are not even aware of the existence of such papers. Again, because of the heavy workload, the staff cannot and do not keep up with what is happening in the rest of the Fund, let alone outside the Fund. Our intellectual capital is eroding. It needs to be restored by according it the priority it deserves in our budget deliberations. I would liken this situation to one where a member country reduces its capital/expenditure outlays to the detriment of future growth. This, I fear, is what we are doing.

On other matters, I wish to associate myself with those Directors who have questioned the wisdom of across-the-Board budget cuts. This is an easy solution but is far from efficient. We know that. And we have more often than not advised members who were in need of budgetary consolidation to refrain from this practice. Let me use the Middle Eastern Department's financial year 1997 work program for the medium term to illustrate the point. In addition to the increase in the department's regular work--consultations and program/intensive cases--there have been qualitative changes in the region that have surfaced this past year. These include the "Mediterranean Basin Initiative" which is providing substantial balance of payments support for countries in the region who are engaged in meaningful reform efforts. This endeavor will most likely rapidly increase the Department's work in its regional and country-specific areas. In this same vein, the economic challenges raised by the peace process, including the new intensive work on the West Bank and Gaza, will involve the Department in additional work. These are specific new areas pertinent to the Middle Eastern region. In view of this, an across-the-board cut in staff would be an inappropriate policy; and the base-period orientation of the budget in the face of these changes is no longer valid. I am aware that the problem of base periods is universal. But we need to address the changing circumstances where they are so evident. These considerations have rightly led the Department to conclude that, with unchanged budgetary resources, cuts in other areas would be detrimental not only to carrying out high-priority activities but also to such crucial areas as staff training and professional development areas, as well as general supervision and administration. I note that in the Managing Director's proposal the redeployment of staff toward priority areas is contemplated, and I hope the Middle Eastern Department will be allocated its fair share. I am sure that similar issues could be found in other regions of the Fund. In this connection, I would note here that while I would support calls made by a number of Directors to better prioritize the Fund's activities and in the process to eliminate certain functions, this would be conditioned on a clear definition of the functions and explicit Board agreement on their elimination.

In conclusion, I hope have not imparted the idea that I do not attach importance to budget consolidation in this institution. Far from it. I am, however, deeply concerned that we are now cutting into the bones. Excessive consolidation has in my view not only reached the counterproductive area but has gone beyond that. I am sure we shall not lose sight of the dangers associated with mere budget consolidation to the neglect of other crucial areas such as the quality and effectiveness of the institution.

Mr. Evans made the following statement:

I would like to start with some basic principles of budgeting, examine the extent to which they are currently in operation in the Fund, and suggest some conclusions about where we can from here. I agree with previous speakers on the need to maintain the high quality and effectiveness of the Fund's work, so that it meets the needs of members according to its mandate. I also agree on the need to ensure that the staff is not faced with unreasonable demands.

We should seek five basic objectives: a medium-term framework; a hard budget constraint couched in actual money; a system for reconciling limited resources with new and sometimes expanding demands; transparency in an information system that concentrates on the outputs of the institution; and a control system that provides maximum incentives for staff and management, and even Directors, to search for efficiency gains. Similar principles were set out in the joint memorandum put forward by Mr. Bergo, Mr. Clark, Mr. Newman, Mr. Waterman, and myself, and similar principles can also be found in the staff paper on guidelines for fiscal adjustment (SM/95/246, 9/21/95).

How do Fund practices, as set out in the Managing Director's memorandum, square with these principles? First, the Board, the staff, and the management have always emphasized the need to have a medium-term framework for all Fund members; yet, in his memorandum, the Managing Director suggests that, owing to uncertainties about the future, any decision on the level of budgetary resources for the future be postponed until next year. I do not believe that the uncertainties currently facing the Fund are exceptional compared with the past 20 years. Moreover, the argument that the level of uncertainty makes medium-term planning impossible is not only wrong, but also perverse. The greater the uncertainties, the more important it is to have a medium-term budgetary framework.

Second, it is encouraging to note the statement in the staff paper on the midyear review of the budget that administrative expenditure for the current year will be kept within the budget ceiling. However, for the future, Directors have been asked to endorse a proposition that is couched in real terms--i.e., in terms of the number of staff--and makes only an arbitrary, and I suspect too small, allowance for increases in compensation. We need a system that allows--and, indeed, encourages--some connection between salary increases and the total budget. Under the present system, the Board is asked to decide on administrative costs and the number of staff, and then to add on whatever is decided for salaries. I do not take great comfort from the statement contained in Mr. Ouattara's memorandum of December 8, 1995 that this approach will be studied further. Clearly this matter warrants urgent consideration. As to dollar budgeting, I favor moving rapidly in the direction started some years ago.

Third, the present system is inadequate in terms of reconciling our limited resources with new and expanding demands in order to establish firm priorities.

Fourth, some progress has been made in improving information systems and transparency, in terms of looking at output indicators, classifying Fund expenditures in a way that makes possible sensible choices among lists of priorities, but more remains to be done.

As to implementing a control system that provides maximum incentives for efficiency, we should give the maximum in flexibility to spending units to meet their objectives, through whatever mix of expenses--salaries, permanent staff, consultants, and travel--they deem necessary. The Board should approve only the totals, not subtotals. I gather some progress has been made in recent years, but further steps can be taken.

There is a very natural tendency to assume that, because the Fund staff is in most cases already very busy, any additions to the work load should be accompanied by extra resources. However, that assumption pays insufficient attention to two points. First, being busy is an indicator of input, not output. Second, old priorities must fall away, so we can redeploy resources. Given the not-so-great track record of the Board in doing this, we have to leave a great deal of it to management. Nevertheless, as the Whitome report pointed out, the most effective way to concentrate on priorities would be to reduce staff numbers.

We need to have a medium-term program for budget consolidation. I would like that to entail a gentle reduction in real terms, because there is a long-term tendency for the Fund to grow. Comparisons of the 1950s, 1960s, 1970s, 1980s, and 1990s show how powerful the growth trend has been. This trend has been in response to perceived and substantial needs--the oil crisis, the debt crisis, and the accession of new members. Nevertheless, if we are to avoid a continuation of that trend, and, at the same time, respond to the additional needs that come up from time to time, we need to aim for a gentle downward trend between crises and other major events. By "real terms," I mean dollars less general price increases.

The Managing Director's proposal for 1996/97 represents a small increase in the budget in real terms. This is liable to be increased by later salary adjustments and is, therefore, too high. I could accept no real increase as defined above.

Although I welcome the fact that the most recent proposal by management goes a little further toward securing a downward trend than previous proposals, I believe that, even with a more realistic estimate of next year's salary increase, a slight tightening of the option for zero change in real terms is achievable. It is to be hoped that the next budget paper will set out more options, including a zero real increase.

Mr. Mesaki made the following statement:

As the Managing Director indicated, the work load of the Fund will increase and most of this increase will come from the strengthened surveillance initiative. Since surveillance-related work consumes much of the staff's time, an increase in the number of staff in this area is unavoidable. It is also important to maintain the high quality of the staff's work without placing an excessive burden on staff. In this connection, I look forward to the Managing Directors' response to the concerns expressed by Mr. Shaalan regarding the "erosion of intellectual capital."

Efforts at budgetary consolidation should nevertheless continue to be pursued. The Managing Director's proposal to reduce the authorized ceiling by 10 staff years and transfer resources from the nonsurveillance departments to surveillance departments is a middle ground between the first option and the third option which were discussed at the previous budget committee, and this seems well-balanced. I commend his effort.

One of the most important criteria in judging a budgetary plan is whether expenditure is at the lowest possible level at which the Fund can fulfill its expected role. Since there will be a small increase in effective staffing and small gains in productivity as a result of the ongoing investment in technology, if the Managing Director's proposal is actually implemented, the impact of the reduction in authorized staff on the Fund's work capacity will be limited. In any case, the balance between the need for budgetary consolidation and the Fund's expected role should be monitored carefully in the future.

Although the Managing Director's memorandum notes that our efforts at eliminating lower priority activities have been somewhat less successful, this institution must come to grips with this problem in order to keep an appropriate balance between resource needs for strengthening surveillance and budgetary consolidation. In this respect, the reduction in authorized staff must be implemented by targeting specific low-priority activities for reduction or elimination.

The joint letter of the Nordic, Canadian, U.K., U.S., and Australian chairs suggests that the Fund move rapidly toward dollar budgeting, and this issue is closely related to the prioritization problem. It might be true that decentralization of the budget will enhance cost consciousness among departments or divisions. However, as this chair pointed out at the previous budget committee, it should be recognized that decentralization itself will have its own cost. I think it would be going too far to totally transfer budget authority to the head of each department or division within a dollar-denominated resource ceiling. I share Mr. Geethakrishnan's view in this respect. Also, I would note that the budget formulation should continue to be based on inputs, especially the requirement of number of staff years.

It is projected that the dollar budget will increase by 1 percent. Needless to say, the level of the dollar budget crucially depends on the increase in staff salaries. On the other hand, the issue of how to preserve the Fund's competitiveness in the international labor market is a very important aspect of any discussion of staff compensation. Since this issue will be discussed at a later stage when all the necessary data become available, we should not presume that the dollar budget can be determined a priori at today's Board meeting.

Mr. Schoenberg made the following statement:

I welcome the Managing Director's memorandum on the budgetary outlook in the medium term. I especially welcome the proposal to continue to maintain the consolidation momentum of the past two years by implementing a reduction in the overall level of staffing for financial year 1997. The proposed reduction of 10 staff years in the authorized ceiling represents a compromise of the opinions expressed by various Board members at previous meetings of the Budget Committee. In the face of increasing work loads in some areas, a continuation of the consolidation effort can, and must, be met with a stronger prioritization of Fund activities. As the Managing Director's proposal reflects many of the views expressed at previous meetings, I can support it.

The Managing Director's proposal is certainly a step in the right direction. However, I share the view expressed by Mr. Evans that the budgetary path we should follow in coming years is not clearly illuminated in the staff papers. It would be especially helpful if management could present a number of different medium-term scenarios, not only in terms of actual dollars or total staff years, but in terms of alternative choices for levels of activity and different tasks the Fund is performing.

Such a menu approach could explain the effects of decreasing certain activities while increasing others on the overall budgetary outcome. Ultimately, such strategic choices must determine the size of the Fund and its budget in the medium and long term, and not focus only on making marginal changes in existing staffing levels or in overall budgetary numbers.

At the last meeting of the Budget Committee, I suggested a possible definition of the concept of budget consolidation. The proposal currently under consideration relies on a slight reduction in the authorized number of staff as a means of consolidation.

Another dimension of consolidation deals with the budget in nominal terms. Consolidation normally entails a constant real, or sometimes even nominal, level of expenditure. As I have indicated on previous occasions, such a consolidation effort would conflict with another important arrangement of this organization; namely, the formulas used to determine staff salaries. If the nominal budget is kept constant in real terms and the U.S. dollar continues its decline against other major currencies, as in the past few decades, the Fund would either have to continuously reduce its work force just to keep wages competitive with European and other markets or, if the work force is kept constant, experience a continuous decline in the competitiveness of its salaries in strong currency countries. Neither alternative can be seen as appropriate

Against that background, we should define the budgetary consolidation in terms of keeping the budget constant in real SDR terms. This does not mean that we would change any part of our budgeting from U.S. dollars to SDRs, but that the political constraint of consolidation being placed on the budget would not collide with the wage formulas. Whether this can be achieved through defining the consolidation constraint in SDRs or by some other means is a secondary issue. The most important goal is to ensure that the wage formula will not be unintentionally impeded in the name of budget consolidation.

Mr. Berrizbeitia made the following statement:

I would first like to associate myself fully with the contents of Mr. Shaalan's statement. In this respect, I would first emphasize that we must be careful that the Board's well intended efforts toward budget consolidation should not and cannot result in overworking, or overstretching of staff resources, particularly the staff of the area Departments and other country-related staff, which seem to be increasingly overworked, nor in any further erosion of the Fund's intellectual capital as described by Mr. Shaalan. The Fund's commitment to excellence cannot be compromised by a well intended but possibly ill focused determination to reduce administrative and capital budgets.

Budget consolidation should not be achieved through across-the-board budget cuts, but through re-allocation of slack resources, if these exist, through efficiency gains, where possible, including through increased investment in technology and human capital, and through reduction or elimination of specific activities that would have to be specifically identified by the Board.

In this context, the Managing Director's memorandum makes it very clear that the intensity and complexity of the Fund's activities are not likely to decline in the foreseeable future and, correspondingly, that the demand for Fund resources is unlikely to diminish. Using the Executive Board's own workload as an indicator, as well as the increased work load demands that are being placed on staff and management by the Board itself and by the Interim Committee, my general appreciation is that the Managing Director's estimates of the work load are, if anything, underestimated. Therefore, like Mrs. Cheong, I doubt whether there is much further room for tightening the administrative budget, without compromising the quality of the Fund's services.

Nonetheless, on the basis of the Managing Director's better informed opinion, I can support his proposal to reduce by 10 staff years the authorized staff ceiling for fiscal year 1997, instead of the 40 staff years that had been tentatively discussed previously, on the understanding that such a reduction in the ceiling will not in fact result in an actual reduction in effective staffing, because of the offsetting effect of vacancy filling. Together with an appropriate redeployment of staff in those areas which have been identified as possible candidates for small staff reductions, and barring any new and unforeseen emergencies, it is to be hoped that the Fund will be in a position to meet its ambitious objectives with the same degree of efficiency and excellence which we have come to expect from the Institution. This said, I am still concerned with the issue of erosion of human capital as discussed by Mr. Shaalan.

Like Mr. Mesaki, I consider that the overall dollar budget cannot be determined a priori in this exercise, until salary adjustments are decided later on in the context of the need to maintain the competitiveness of the Fund to attract the highest possible quality of staff from a broad geographical spectrum. In this context, Mr. Schoenberg's suggestion to use an SDR-based budget exercise deserves further exploration.

More generally, however, in order for the Board to be able to provide guidelines for budget optimization and specific activity reduction, it needs to be supplied with budget information presented in such a manner that can serve as an effective management tool. In this respect, with the exception of some very general indicators contained in the Managing Director's memorandum, and the Table contained in the supplementary document, I do not consider that the type of information which has been provided for today's discussion is generally adequate for these purposes.

Although I am no budget expert, I feel certain that indicators can be developed, that cut across departments, activities and time horizons, and which would allow both management and the Board to better evaluate the Fund's productivity and efficiency, and thereby allow a more informed decision-making process on budget issues. I will continue to insist on progress on this subject in our Budget Committee.

Finally, I strongly support for the views expressed by Mrs. Cheong regarding the importance of the Fund's technical assistance program and of its contribution to economic stability and growth to developing and transition economies, and I take this opportunity to express my Chair's appreciation for the valuable support provided by the Japanese government to the Fund's technical assistance. We must keep the importance of this issue foremost in our minds as we continue to search for ways of optimizing the use of the Fund's resources in the future, in order to ensure that such programs are not debilitated. In this context, if it is agreed that changes to the current policy on country contributions for technical assistance are necessary in the future, such changes in policy should be implemented in such a manner that will not result in countries becoming inhibited from requesting technical assistance in the future.

Mr. Clark made the following statement:

Your effort to continue budget consolidation in fiscal year 1997 is appreciated by this chair. Events of the past year have kept the pressure on the institution and its able staff. In this respect, the Fund employees deserve considerable recognition for having continued to produce competently and gracefully under pressure.

With respect to the proposal for 1997 and onward, I welcome the presentation of institutional objectives as laid out on page 9. I must say that these are cast at a fairly general level. The next step would be to identify and organize activities which best contribute to achieving these "objectives."

The budget process has improved considerably over the past year or so, including communication between the Board and management about budget methodology and Fund priorities. Referring to the memo signed by a group of Directors in November, many of our suggested guidelines are being pursued although as many Directors have mentioned, we should try better to integrate the realistic salary assumptions.

The assumption of no real increase in salaries appears optimistic at best given the developments in exchange rates over the past 18 months and the associated pressures expected on the compensation system. It is clear from the structure of the salary system, the increase proposed is likely to be considerably higher than assumed here. This will raise the increase in the total administrative budget.

Indeed, with respect to salaries and budget process, in the past, we have stressed the importance of integrating all related issues, such as staff compensation and the work program, into the budget process to ensure a more cohesive approach. While this receives honorable mention in the report, I would like to see more concrete proposals to bring the various elements, particularly compensation, together. Salaries make up 70 percent of the budget, so it is not logical to make budget plans without a realistic assumption on the principal item.

This being said, I think it an excellent and persuasive budget submission. But the bottom line is that my Canadian authorities to do not want to support more than a zero-nominal increase; and there are supply versus demand approaches to budgeting:

To try to square this circle--or at least identify the dilemma--let me speak of two different approaches to budgeting: demand-based budgeting; and supply-based budgeting

I have not heard these terms used before, but I am sure I am not the first to use them. It occurred to me that the history of public expenditure management in the last decade in Canada and many other member countries can be characterized as a shift from a demand-based to a supply-based philosophy of budgeting.

The document before us falls into the honorable tradition of demand-based budget submission, and is thus similar to submissions that Canadian treasury departments used to see a few years ago.

As noted, this is an excellent submission in this genre. It has most of the right elements: a good description of budgetary strategy; a credible review of work-load developments; an overview of institutional objectives; and a link to the work program.

There is also a credible description of the increase in per-person workload, and I see no reason to question the assertion in Mr. Shaalan's statement that many of the staff are working longer hours and that the institution must consider the effect on intellectual capital.

As noted, I would like to see a better link to salary budget, given the fact that the salary formula is likely to produce higher requested numbers than the assumption in the paper--however, this is really a procedural quibble and does not negate the fact that from a demand-perspective, the Managing Director's proposal appears well justified.

Turning to supply-based budgeting, to understand where my Canadian authorities are coming from you have to understand the extent of the budget consolidation that is under way in that country. The total program spending in nominal terms will decrease by almost 19 percent from fiscal year 1994-95 to 1997-98, with: health down by 5 percent; defense by 12 percent; general government services by 16 percent; development aid and agricultural support by 21 percent; industrial and regional development by 50 percent; and transportation expenditures by 50 percent.

This is not to say that the demand for these services has decreased. Indeed, most of these sectors have made the case in the past that the demands placed by a growing population, price increases, and by specific requests of Cabinet ministers would justify increases in budgets.

Nevertheless, the budgets had to be reduced because the supply of funds was the binding constraints.

From this supply-based approach, one could impute the priorities that my Canadian authorities attach to the Fund and its work, that is, higher than Canadian transportation, industrial, and agricultural support; higher than bilateral development aid; higher than national defense, despite new constraints in Bosnia and elsewhere; and higher than general support for health and education. Indeed, the only major area which is receiving normal increases in spending on aboriginal health and housing.

This leads to the logic of the hard budget constraint. The Canadian experience suggests this can lead to creativity and hard choices that can even strengthen the institutions in the longer term.

To some extent this is the Alan Whittome line. While it may not be gospel, it is increasingly the reality among our member countries.

So, where does that leave us today? Although I appreciate management's intentions in the proposal before us, the approach employed is not transparent and makes it difficult for any of us to achieve our objectives. In this respect, I would suggest that the medium-term framework provide a basis to set a dollar-determined goal, say for example, zero nominal or zero real growth. In this way, the process will provide management with the flexibility to decide on the number of staff required, how much they want to pay whom, and where they want to deploy them, all the while sticking to a global constraint. This is consistent with the work I mentioned earlier on devolved budgeting which is designed to improve the system.

From this vantage point, my authorities feel very strongly--by political economy realities--that budget restraint efforts being undertaken by governments in most countries, like France, the United States and Canada, should be emulated to a greater extent by the Fund. In addition, in view of the budget context in other multilateral financial institutions, my authorities insist on seeing a zero nominal increase in the administrative budget--and I mean the actual outcome, after salary increases. While the Managing Director's proposal appears to come close, in reality, it does not when account is taken of: the one-off effect arising from the reduced contribution of $10 million to the retirement plan; and the likely salary outcome.

The Chairman commented that the proposition that reducing staff numbers would be the most effective way to concentrate on priorities did not really apply to the Fund. Although the current low level of staffing in the Fund might help to explain its efficiency, creativity, and effectiveness, the staff was already stretched to the breaking point. Any further reductions could be counterproductive.

Mrs. Cheong noted that consolidation did not necessarily mean "reduction"; rather, it meant ensuring that increases in supply were equated with increases in efficiency. The demands currently being placed on the Fund were a matter for concern in that respect. Despite the introduction of new technologies in the Fund, the staff was still working very hard and for very long hours. She disagreed with Mr. Evans's statement that working longer hours did not necessarily mean more output. In the context of budget consolidation, it was always important to look at the tradeoffs involved. For example, the Fund frequently approved additional spending on infrastructure by countries undergoing fiscal consolidation programs, precisely because such spending resulted in greater value added. The Fund should examine the value added in its own budget choices to ensure that it could continue to provide vital services to its members.

Ms. Lissakers made the following statement:

Today's discussion focuses on the Fund's budgetary plans over the medium term. I would like to start, however, by quickly citing some figures that put the past couple of years of budgetary consolidation in perspective. I do this because there is the perception--mistaken I believe--that there have been dramatic cuts in staff resources at a time of increased workload. In fact, effective staff resources have been increasing, not declining.

Authorized staffing has increased 25 percent since 1991. We have gradually been filling those slots. Thus, actual staff working in the institution increased by 57 this fiscal year. The Fund's administrative budget has increased by 70 percent since 1991.

Earlier this year we agreed to shrink the number of authorized staff by 40, but since externally financed positions rose by 23, the resulting net reduction in total authorized staff was only 17. As I noted, actual working staff increased.

In addition to the rise in the quantity of staff, there is also the reasonable expectation that their quality should be increasing as well. Many of the new staff are no longer so new--they are more seasoned and productive. Also, the Fund has invested heavily in new technology, particularly in computers and software. In our view, therefore, one should not approach today's discussion under the false impression that cuts have been made. The workload indeed has increased, but so have the resources to carry it.

Having said that, I do not doubt what Mr. Shaalan says in his statement is true. I think there are overstretched staff. I do not think, however, that the condition is universal or reflects an overall tightness of resources. More likely, it reflects a sluggishness in shifting staff from areas of low priority to high priority. The Managing Director states in his memorandum that ". . . our efforts at eliminating lower priority activities have been somewhat less successful." The memorandum does not elaborate on the reasons for this. Perhaps the Chairman could give us his views on why this is so. The sub-text to this point is that an improved budget process could help us shed lower priority activities or at least recognize the trade-offs involved. With greater transparency and improved management, including through devolved budgeting, greater efficiencies could be achieved.

There should be no retreat from the Managing Director's medium-term plan for budgetary consolidation. The most effective means for achieving prioritization and more efficient operations is a budget ceiling. The Managing Director's proposed 1-2 percent real cut for financial year 1997 is consistent with this goal. This objective has our full support. Its attainment is doubly important given that the $10 million windfall arising from favorable returns on pension fund assets is not likely to be repeated in future years. We are concerned, therefore, about uncertainties in the budget process which could complicate attainment of this goal unless properly accounted for.

There are three variables which can and do play key roles in determining actual budget outcomes: the staffing levels, salaries and related costs, and revenues. Strategic decisions on these variables must be taken together so that separate, technical deliberations take account of the implications for the broader budgetary picture. We are concerned, for example, that current projections assuming a 3.5 percent salary rise may prove unrealistic given that salary discussions will not take place until next year. In these circumstances, it makes little sense to decide on staffing figures at this stage. If we were to lock ourselves into staff levels now, then management and the Board would need to be prepared to use all available discretion in the salary discussions in order to achieve the overall budget target.

Consolidation means spending levels, not staffing levels. We should maintain our flexibility in order to achieve that goal. We should aim to achieve the Managing Director's proposed budgetary outcome for financial year 1997 ($477-$481 million), and make final decisions on staffing and salaries with that target in mind. The potential for cost recovery must also be a more central factor in our deliberations. The amounts involved may not be large relative to the whole budget, but at the margins they can make a significant contribution to desired fiscal and staffing outcomes. The application of a more realistic schedule of user fees on technical assistance has been a topic of active discussion. We look forward to a conclusion of these deliberations in time for incorporation of a more realistic fee schedule into financial year 1997 budget considerations.

In short, management and the Board need to make decisions that are based on developments and trade-offs in all three of these areas. The process would be greatly facilitated by functional output presentations that portray the implications of different staffing and salary scenarios. We look forward to refinements that will make this possible in the near future. Deliberations will would also benefit from an adopted strategy of priorities, a topic to which I will return.

Over the medium term, our efforts need to focus on the following:

First, we need to have an actual medium-term budget strategy that includes targets. I take the Managing Director's point on uncertainties, but these will always exist. We need to establish goals and adopt a flexible and adaptive posture in order to achieve them.

Achieving budgetary consolidation over the medium term will require action now to accelerate greater efficiencies. This should include exploration of a wider use of devolved budgeting. Top-down guidance is essential for allocating resources. But greater bottom-up discretion (with appropriate safeguards) through devolved budgets is key to producing efficiencies.

Additional productivity gains can be found in better personnel management. We note that the effective staff cuts contemplated under Scenario 1 in the paper presented to the Budget Committee were much less than the number of staff--45--that management identified earlier this year as unqualified and sought to separate--through an overly expensive scheme, unfortunately.

As I have stated, both the short-term objective of achieving the Managing Director's budget target as well as medium-term budget consolidation goals would benefit importantly from the adoption of a strategy of priorities. I am encouraged that "for the future" the Managing Director wants management and the Board to adopt a strategy of prioritizing work. I think we need to bring this process forward. Given the requests from an increasing number of chairs for such a strategy, management should challenge the Board with an explicit statement of priorities. We may not all agree on the outcomes, but I think there is a strong desire for greater transparency over the process in which resources are allocated.

Mr. Prader made the following statement:

We can generally accept management's medium-term budget outlook and support continuation of the medium-term budget consolidation orientation. We subscribe to the basic objectives and the work priorities outlined in the Managing Director's statement, in particular the emphasis on shifting more resources to surveillance activities. However, we very much share the concerns of Mr. Shaalan and Mrs. Cheong, and we do have certain reservations. These are:

First, the fact that the management's recent presentation of budgetary options includes a suddenly emerging new budget option and that the budget projection relegates the crucial issue of staff compensation to a footnote, despite explicit requests from the Budget Committee for a study of this issue before the Board discussion;

Second, problems in the implementation of budget policy, and particularly the problem that the response to budget tightening often takes the form of reducing Fund services for the smallest, least influential members. Another well-known but consistently ignored problem is that the composition of Fund missions and divisions is too frequently changed, impairing the quality and continuity of the advice provided to member countries. On average, staff members seem to work on a given country for only 18 months, while mission chiefs are changed even in the midst of critical periods of surveillance and program discussions. Small countries perceive a crowding out effect in the sense that it seems difficult for the Fund to find enough staff to man its missions to the so-called less important countries. It is hard to avoid the impression that during a period of budgetary retrenchment, the principle of Fund staff mobility is being placed ahead of the interests of member countries. We also fail to see how the announced redeployment of staff from statistics would be consistent with the objective of strengthening the provision of economic and financial data to the Fund for surveillance.

Specifically on the issue of the presentation of budgetary options, I have followed the management's presentations of the medium-term budgetary outlook with great interest, both in the Budget Committee and in the Managing Director's statement today. In the Budget Committee, I joined other Directors in indicating support for the original Option 3, on the grounds that it was consistent with the medium-term budget consolidation strategy, and reasonably ambitious because it contemplated an unchanged staffing level despite the increased workload. I still feel comfortable with Option 3, and would therefore support it if others do likewise. However, "after further reflection," management has now surprised us with a revised Option 3--or an Option 4--which "on the basis of the prospective work load now envisaged" announces a reduction of 10 staff years in the authorized ceiling. The sudden change of management's perception of the workload raises, in my view, questions about the degree of reality of the budget scenarios and discussions. Or maybe it is an issue of lack of transparency of the budget documents, as some Directors have suspected.

Of course, I am happy that the budgetary costs are projected to be lower than previously assumed, but I also wonder how such additional savings in staff years could be found so easily and quickly. Was the workload overestimated just a few weeks ago, or did management have a margin of room for maneuver in terms of downsizing which it chose not to reveal to the Budget Committee at that time? Like others, I have till now been under the impression that the Fund's workload has, if anything, increased rather than decreased over recent weeks. One has only to look at the Fund's involvement in the Bosnian peace process as the most recent example of additional work pressures. For instance, our constituency was told by the European Department that despite prior understandings about a certain work project, there were no more resources available for one of our member countries because of the new demands connected with the Bosnian case.

In any event, while we endorse the management's course, we might conclude after our experiences with the Fund's budget process that there is perhaps more flexibility in staff resources than has so far been revealed to the Board. This flexibility becomes all the more important in light of the question, raised by Mr. Schoenberg today and in the Budget Committee but unfortunately not answered in the documents submitted for today's discussion, namely: How can the impact of the significant dollar devaluation on staff compensation be reconciled with the assumption that budgetary expenditures will grow by only 1 percent in nominal terms, bearing in mind that salaries and benefits account for over 70 percent of total administrative expenditures? Obviously, the assumption of an unchanged real value of salaries and benefits in U.S. dollars for financial year 1997 implies that the effects of the dollar depreciation on staff compensation is being ignored.

However, we have difficulty in accepting the likely adverse consequences of this policy for the international composition of the Fund's staff. Confronted with a choice between a further deterioration in the nationality distribution of the Fund staff and further cuts in staff in order to release resources to maintain the Fund's salary competitiveness, we might be forced to choose further reductions in the number of staff when the time comes to consider the budget proposal for financial year 1997. To avoid such dilemmas, we are interested in Mr. Schoenberg's proposal for a new definition of the budget consolidation in terms of a constant budget expressed in SDRs.

Finally, like Mr. Mesaki, I take a cautious position on dollar-based budgeting. As long as we do not have satisfactory answers concerning the impact of dollar budgeting on the nationality distribution of the Fund and other aspects, we would reserve our position.

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

Mr. Al-Tuwaijri made the following statement:

I join other Directors in welcoming the improvements achieved in the Fund's budgetary process over the past eighteen months. The detailed staff papers and the discussions in the Budget Committee have been most useful in addressing the questions and concerns of the Board. This progress notwithstanding, there is still ample room for improvement. In particular, I believe it will be most productive if the costs of proposed initiatives are clearly identified. It is encouraging that there is movement in this direction, as evidenced by the cost analysis in the paper on group travel. A useful way to advance this process would be to assign, on a trial basis, preliminary cost estimates to each of the main proposed items in the work program. This will hopefully help the Board to make more informed decisions.

Having said this, let me turn now to the Managing Director's proposals on the medium-term budgetary outlook. In addressing these proposals, one needs to look at a number of factors including: increased productivity of the staff hired during our rapid expansion; substantial increases in the Fund's workload. In addition to the rise in program intensive cases, the Board has approved a number of initiatives over the past few months with substantial impact on the workload. There is a need for the Fund to respond quickly to crises and the increased involvement in capital flows issues. There is an increased demand for technical assistance, which, like the training by the Institute, is highly valued by member countries. This is especially relevant at this time in view of the strengthened surveillance and the publication initiatives. There is a need to maintain working conditions for the staff and the need to maintain the high quality of our output. In this regard, I believe there is broad agreement in the Board that the staff's already heavy workload is likely to get heavier.

Taking all these considerations into account, my preference is for maintaining the current level of staffing until we can better assess the impact of the new initiatives on the workload.

However, I can support the Managing Director's proposal if the proposed reduction in authorized staff can be achieved without overburdening the staff or diluting our core services and advice to our members. In this regard, the Central Asian Department's approach to address resource constraints by spending less time on non-core activities, such as military spending, environment, poverty, etc., is sensible and hopefully will be emulated throughout the Fund.

On the issue of dollar budgeting, I agree with Mr. Geethakrishnan that before taking a position, it is important to assess the Bank's experience in this area. The impact of a move to dollar budgeting on the recruiting practices and diversity of our staff would also need to be assessed.

Mrs. Coronel made the following statement:

Commitment to budgetary consolidation is a strategy that we welcome more than as an objective per-se, if considered in the context of the membership needs contained in the work program of the Institution. The papers before us describe clearly this work program and conclude that it will continue to be intensive, wide-ranging and complex. The allocation of resources to finance the new demands will obviously have to face some constraints, but the difficult task is to set the ceiling at a level where all planned activities could be effectively achieved without placing an unreasonable burden on the staff.

The conclusion to set that ceiling at a level that implies a reduction of 10 staff years in financial year 1997 does not easily flow from the analysis. We are told that the Institution is operating at close to maximum capacity and that an increasing work load should continue to be undertaken during the next year. Then, the proposed budget reduction would be largely met through interrupting or delaying low-priority activities. Yet past efforts in this regard have been achieved with only limited success. It is not clear to us, in this context, which subset of activities could be considered less important and, given the past experience, to what extent we will be able this time to abandon them successfully.

Given the anticipated redeployment requirements, we do not favor across-the-board reductions, but rather reductions in selected work activities which, as I said before, need to be clearly identified. As we have stated on previous occasions, and like Mrs. Cheong, we would be particularly concerned about budgetary cuts in technical assistance. We note from the tables presented in EBAP/95/101 that although some extra budgetary resources would be allocated for technical assistance in the Statistics Department for financial year 1997, a cut of 3.7 staff years is envisaged in the case of the Monetary and Exchange Affairs Department, and a reduction of 0.5 staff years is programmed in technical assistance provided by the Fiscal Affairs Department. The proposal to maintain, for the medium term, the current level of internal resources devoted to technical assistance might be somewhat conservative if considered that the level of demand continues to be greater than the capacity of the Fund to deliver. We strongly believe in the interaction between technical assistance and surveillance to meet the expectations of stabilization programs.

Finally, while we appreciate that a clearer understanding of the work load for financial year 1998 and financial year 1999 would allow for more precise decisions on the level of budgetary resources for those years, we consider that it would be still useful to make some assumptions in this regard in the context of our knowledge at this stage and include these in the projections. It should be expected that as additional information becomes available, it would be reflected in future medium-term budgetary exercises.

Mr. Kaeser made the following statement:

At the outset I would like to thank the management and the staff for the excellent material provided the Board for today's discussion.

I very much appreciate the commitment of the Managing Director to continue "to support the consolidated budget strategy of restraining administrative expenses to little, or no, real increase by using productivity gains and work practice improvements to meet the increased work demands and/or to reduce the staffing level whenever possible." I note with satisfaction that management did curtail actual spending during the first half of financial year 1996 in order to keep total spending for the whole of this fiscal year within the approved budget. As management gives us new proof of budgetary discipline, I do not think that the main concern of the Board should be directed at the expenses. However, in this regard, Mr. Schoenberg and Mr. Prader made interesting suggestions concerning the concept of consolidation which deserves further consideration. In contrast to this, I cannot share the logic of the Canadian authorities who would like to punish the Fund because Canada has had to accept tight budget constraints after a long period of budgetary indulgence.

The main concern of this Board should be to keep the Fund as lean as possible, with a swift and efficient decision-making process. Bureaucracy is already spreading throughout this institution. The circulation period of documents inside the Fund machinery between the first draft and the final approval given by management has increased over time--the result being a shortening of the circulation period in the Board and an increasing number of waivers. This means that we should mainly be concerned with size of the Fund, and that means with the size of the staff.

During last year's discussions on the Budgetary Outlook in the Medium Term, the majority of the Executive Board agreed with the Managing Director on a reduction in authorized staffing levels of 1.5 percent for financial year 1996 and a similar target for financial year 1997. The discussions of the budget for financial year 1996 showed that the underlying assumptions concerning the work load had to be revised upward, mainly because of the strengthened surveillance initiative. However, this did not result in a revision of the targets for financial year 1996, as the impact in terms of additional need for staff years was not clear.

We agree with the Managing Director that additional tasks conferred to the Fund will call for additional human resources. Nevertheless, the original momentum of consolidation should be maintained. Thus, if the original task for financial year 1997 was a further reduction of 40 staff years and the additional need from new activities should amount to 20-25 staff years, a reduction of 15-20 staff years could still be aimed for. However, we still do not know precisely by how much the work load of the staff will increase due to the enhanced surveillance and, therefore, we consider the Managing Director's estimate of an additional 20-25 staff years as a working hypothesis. The more detailed resource proposal promised for March 1996 should allow us to make a more precise estimate.

As regards the implementation of the reduction in the level of authorized staffing, we agree with the Managing Director that it should be achieved mainly through priority setting and reducing specific activities.

Such decisions are within the domain of management and the Board should be cautious in formulating recommendations. If I remember well, in the relatively recent past, the recommendation of the Board has been to curtail the staff of the Western Hemisphere Department! Nevertheless, I think that it is useful for management to hear the views and recommendations of the Board concerning the allocation of personal resources.

The demand for technical assistance, which belongs to the category of development aid, is virtually unlimited. Therefore, we should now put a ceiling on the supply if we do not wish to see this activity growing out of all proportion. In this field, we should establish strict prioritization and advise member countries to revert to bilateral donors, or to private consultants. The Fund could help member countries in the selection of serious consulting firms, as the World Bank does.

I would personally not rush to curtail external training in the next few years, as it plays an important role in institution-building, but a reduction should be possible during the last few years of the century. The same may apply to the Bureau of Language Services, because we can expect that new member countries will gradually be able to abide by the Fund's rule of communicating with us in English. Paradoxically, I would dare to suggest that a margin of maneuver should still exist in the field of surveillance. I am still firmly convinced that we should keep the 12-month cycle for Article IV consultations, but relatively small and sound economies should not absorb as much in personal resources as a large member country or a member with systemic relevance.

Ms. Laframboise recalled that one of the points Mr. Clark had put forward in his opening statement was that increases in the demand for services did not necessarily have to be met by increases in the level of staffing.

Mr. Evans said that he agreed with Mr. Clark and Ms. Laframboise. The imposition of tight budget constraints in the United Kingdom had led to significant improvements in productivity throughout the public sector.

Mr. Kaeser stated that he agreed with previous speakers that the imposition of ceilings on the level of staffing could instill more discipline and lead to improved productivity.

Mr. Petrie made the following statement:

At the outset, I would like to address the comments of one or two Directors who seemed to consider that the budget consolidation strategy is taking little or no account of the Fund's effectiveness and could therefore have a negative impact on the Fund's ability to meet the needs of its members. This concern is misplaced for two reasons. First, budget consolidation, if properly implemented, can be fully consistent with an increase--not a decrease--in effectiveness. Indeed, as a number of previous speakers have noted, the discipline associated with resource constraints can add impetus to efforts to raise the quality of the organization's core activities.

Certainly a key element of the suggestions put forward by Mr. Waterman over the past year for improvements in the Fund's budget, planning, and personnel management processes has been the effort to strengthen the Fund's effectiveness. For example, the shift to a functional presentation of expenditures for the 1996 budget is aimed at ensuring that budget consolidation is achieved in a way that protects and even strengthens the Fund's core activities. I would add that I agree entirely with the views expressed by Mr. Berrizbeitia on the need to develop performance indicators for the Fund's outputs and to generate better information on low priority activities. The functional classification of expenditures should make this easier.

Second, the Fund's budget consolidation efforts to date have been modest. To a large extent, the cut in the authorized level of staffing for 1996 and the proposed cut of 10 staff years for 1997 has been met through a reduction in vacancies, rather than a cut in actual effective staff numbers. As Ms. Lissakers stated, it has been more a slowdown in the rate of expansion, rather than an actual shrinking of the staff. We recognize that there is an additional work load associated with strengthened surveillance, which management has estimated at about 20-25 staff years in 1997. But, at under 1 percent of the Fund's total staff, this is a relatively small increase, and, as management has suggested, it could be met through a prioritization of duties and a reallocation of existing staff, so that core activities are protected.

We continue to consider that there is further scope for reducing the proposed budget in nominal terms and in a way that would be fully consistent with an increase in the Fund's effectiveness. We agree with Mr. Evans that it would be desirable for the staff to develop a budget option entailing no real growth for Board consideration in April 1996. Given that we have a medium-term budget strategy of little or no real growth in expenditure, there would seem to be a fairly compelling argument for including a budget with no real growth among the options for 1997.

We welcome the discussion on institutional objectives in the staff paper on the medium-term budgetary outlook. This can help Directors to focus strategically on both the budget process and the Work Program exercise, although there is a need to better align the timing of the two exercises. The usefulness of the discussion on objectives could be increased if specific objectives were clearly incorporated into the budget figures for 1997. In that respect, I support the suggestion put forward by Mr. Schoenberg that alternative medium-term budget scenarios be developed to reflect key strategic choices.

We welcome the staff's indication that the timing of the staff compensation exercise and the budget processes will be considered further in response to the concerns raised by many Directors. The overall budget strategy aims at little or no real increase in staff numbers. However, the Board is effectively being asked to endorse a proposal that adheres to this strategy without being given a full explanation of what this proposal implies in terms of actual expenditure. Perhaps the staff could prepare a short paper on this issue to be taken up by the Budget Committee within the coming two or three months.

I also wonder whether the staff could comment on the possibility of bringing the annual Board discussions on staff compensation forward a little, say to March each year, to permit the integration of proposed salary adjustments into the administrative and capital budgets.

Finally, although many Directors strongly favor moving to dollar budgeting, there has been no agreement on this issue yet. It would seem appropriate to implement such a scheme in some parts of the Fund on a trial basis, so that the Board could review that issue again in light of experience in due course.

Mr. Martinez Oliva made the following statement:

The central issue at hand is clearly the trade-off between the amount of resources necessary to maintain our institution's responsiveness and the continuation of the budgetary consolidation strategy.

Last year, after a period of increasing staffing needs, stemming from the challenges posed by a new and rapidly evolving international economic environment, it seemed that a tightening was possible. As such, we went along with the Managing Director's financial year 1996 proposal to set a 1-2 percent target for the reduction of administrative expenses in real terms and to reduce the authorized staffing level by up to 1.5 percent. For financial year 1997, the decision was left to this year's discussion.

The documents before us depict a scenario which is different from that assumed in last year's medium-term budgetary exercise. While significant progress has been achieved in terms of financial assistance and surveillance, the workload has peaked at levels hardly experienced before, and is expected to grow further. The continuation of Fund activity in so many areas, along the lines indicated by the Interim Committee, will place an additional burden on our institution in the years to come.

The increase in activity, in the face of a tight budget constraint, cannot but lead to strains which have undesirable consequences for the institution. These strains, if allowed to persist, will bring about a deterioration of what has been defined by Mr. Shaalan as the Fund's intellectual capital, an asset whose unique nature must be preserved. They will also cause the important condition of a "a healthy working environment" to be overlooked, and overburden the staff and the institution by any reasonable measure.

The Fund's ability, displayed to date, to adapt to the changing economic environment must not be impaired by a shortage of resources. A budgetary strategy aimed at a more efficient allocation, and a better utilization of resources remains the best option over the medium term. Budget discipline is indeed crucial for the achievement of those targets, but it should not be overly stringent. The objectives set forth for financial year 1996 are certainly consistent with a strategy of budgetary consolidation, but in a context of rapidly increasing activity they may represent a limit on the functioning of the institution in the future.

I see some risks in continuing this strategy into financial year 1997. The Managing Director's proposal, which tries to provide a compromise between the first option--continuing the planned downsizing of the authorized staffing level by 40 staff years in financial year 1997--and the third--redeploying existing resources within the current authorized staffing levels, while alleviating the stringency of the targets proposed in the first option--is still consistent with the need to maintain the momentum of the process of budgetary consolidation. Therefore, I can support the Managing Director's proposal. Still, as other speakers have pointed out, it remains essential for the future to make further efforts to set priorities in order to eliminate those activities which are less essential for the Fund.

Finally, I would like to support Mr. Schoenberg's suggestion that in the future a number of alternative budgetary scenarios be submitted to the board for discussion. I also join those speakers who expressed concern about the issue of fees for technical assistance and who are of the opinion that the issue deserves further attention in the future.

Mr. Tulin made the following statement:

Today we are facing the difficult issue of setting avenues to find the proper balance between the continuation of the budget consolidation strategy and maintaining the exceptional quality of work that members have come to expect of the Fund. Against the background of deepening the Fund's work on surveillance and data issues, our choice of the spending pattern is very important for full implementation of the Fund's objectives over the medium-term.

During the past year's discussion on the budgetary outlook we were among those who were in favor of the budget consolidation strategy. The general direction of this strategy was aimed at a decrease in administrative dollar expenditure growth in real terms over the medium-term. We continue to support this general direction for 1997, and are generally ready to accept the third option for finding additional resources, as mentioned in the Managing Director's memorandum. Namely, to redeploy existing resources within the current authorized staffing level, thus ensuring the Fund's ability to respond to the new demands. I would, likewise, welcome the Managing Director's revised proposal to go along with the third option but with the preliminary reduction in current authorized staffing by 10 positions. However, I would not like to be categorical at this point due to the following considerations.

First, our main concern remains that the quality of the Fund's work be maintained, and that we should avoid putting unnecessary work pressures on the staff. We are not interested in the budget consolidation strategy per se, and are concerned that implementing it without the most careful consideration may lead to a reduction in the overall quality of output. Downsizing expenditures at the expense of quality is not an approach we want to pursue. The Fund must maintain the high standards of its work. I recall that this idea has been a leit-motiv of our previous discussions for the past two years. And it remains such for the coming period.

Second, I quite share Mr. Shaalan's and Mrs. Cheong's view that we need to invest more in the Fund's human capital. The workload of the staff is heavy, and with the need to perform the new functions, it will get heavier. The dedication of the Fund staff is well known, but working 50-60 hours a week as a norm, does not promote efficiency. A situation that ensures that the staff do not have time to increase their professional level, in our view, is intolerable.

To summarize, this chair accepts the budget consolidation strategy as a desired policy guideline for the upcoming years, provided that this useful approach does not impede the implementation by the Fund of its main functions. If and when the conflict between budgetary constraints and functional activities of the Fund becomes evident and appealing, we should be prepared to reconsider our position and, if necessary, to authorize not only additional compression, but also additional spending in real terms, perhaps on a selective basis. In other words, I am not prepared at this stage to support the concept of a fixed ceiling on budget expenses in the medium-term perspective. I would be more inclined to consider it as a moving ceiling, or another very important variable, which we shall try to minimize, but only in line, and sometimes even depending on, the performance of other variables.

In this regard, I would like to support the Managing Director's proposal to postpone the final assessment of the resource needs for financial year 1998 and financial year 1999 until the next medium-term exercise. This proposal seems quite sensible in view of the necessity to explore different medium-term scenarios for the resource needs in conformity with the Fund's policy objectives.

Mr. Jones made the following statement:

I am in broad agreement with the principle of budgetary consolidation, and management has done a lot to curtail spending in the first ha of 1996 in order to live within the approved budget. I can also appreciate the continued effort management is making to hold the line on expenditure. However, while we support fiscal discipline, we must keep in mind that the Fund is facing many challenges leading to an increase workload and increased demand on the resources of the Fund. In this context, I am concerned that too much emphasis on budget tightening could undermine the capacity of the Fund to undertake its core responsibilities. In fact, it seems that we are at a point where further cuts would be counterproductive.

In pursuing a tight medium-term budgetary strategy, the question of prioritization is fundamental, a point already emphasized by many Directors. In this regard, I join Mrs. Cheong in expressing concern about the provision for technical assistance. Our countries attach high priority to such assistance, and we would like to see this reflected in the medium-term budget scenario.

We also question the wisdom of charging for technical assistance. This might delay the process of institution building in many developing countries, including the capacity to develop appropriate statistics and provide them in a timely manner to the Fund. The surveillance process could suffer because of this.

Finally, I am interested in what Mr. Shaalan had to say about the need to contain the workload of the staff in order to provide time for training and professional development.

Mr. Botoucharov made the following statement:

Before turning to the papers on the budgetary outlook in the medium term, it seems useful to briefly comment on the staff report on the midyear review of the Fund's administrative and capital expenditures (EBAP/95/105). It is encouraging to note that despite the unanticipated increase of Fund responsibilities in 1995, in particular associated with strengthening of surveillance and improving the provision for data, the administrative expenses are expected to remain within the original budget projections. The breakdown of the expenses in Table 1 suggests, however, that the prospective workload for the remainder of financial year 1996 and in the medium term will be heavier than anticipated. More precisely, expenses that are higher than initially budgeted, for instance, expenses for subscription to electronic information services and business travel, are directly associated with the strengthened surveillance initiative. These developments should be kept in mind in formulating the Fund's medium-term budget strategy.

The principal consideration in assessing the medium-term budget outlook is whether the budget strategy is consistent with the anticipated workload. The management's position is that the present strategy of budget consolidation should be continued, albeit at a slower pace, and a further reduction of 10 staff years in the authorized ceiling should be targeted for financial year 1997. The proposed slight downsizing in the authorized staffing level, which actually is offset by a vacancy filling (EBAP/95/100, p. 19, footnote 5), and the expected marginal increase in administrative expenditures, seem to maintain the consolidation momentum. We, therefore, favor the new proposal of the management.

Concerning the implementation of the budget strategy, this chair has two comments:

First, as regards the proposed redeployment and downsizing in the authorized staffing level, we believe that an across-the-board approach could be in conflict with an efficient budget. To this end, a carefully implemented selective downsizing, based on agreed priorities, could serve the Fund best.

Second, the implementation of the budget strategy should be achieved on the basis of mindful prioritization. This would mean that, on the one hand, elimination of low priority activities should not be at the expense of undermining the Fund capacity to respond effectively to any unanticipated developments, while on the other, the Fund should enhance the effectiveness of its surveillance without recourse to increased resources. On this issue, we share the management's view that the efforts to eliminate lower priority activities has been less successful.

Finally, on the budget process, we note that in the past two years the communications between the Executive Board and the management on Fund expenditures has been significantly strengthened. Nonetheless, we believe that the Budget Committee and the management should work toward a better integration of the work program priorities and the budget.

Mr. Saito made the following statement:

Like other speakers, I welcome the progress made in improving the budgetary process and adhering to the medium-term strategy of consolidation despite the continuous increase in demand resulting from virtually universal membership and globalized markets. The institutional objectives of the Fund, as outlined by the Managing Director in EBAP/95/100, fully capture the nature of the Fund's unique mandate. To remain relevant, there is a need both to maintain a healthy working environment and to ensure that the Fund has the necessary resources to meet future demands without compromising the quality of output.

At the same time, the persistence of tight budgetary constraints in most of the membership imposes a special responsibility on the Fund to continue improving the linkage between its budgetary process and the priorities established in the work program, to identify savings from redundant activities and enhance productivity, as well as respond to new demands.

It is difficult to find exception with managements' priorities or its assessment of the relatively small prospects for lessening the overall work load, particularly in projected country-specific work, bilateral and multilateral surveillance, and technical assistance. It is also clear that efficiency gains alone will be insufficient to meet those increased demands. Mr. Shaalan's comments reflect the scope of unsatisfied needs, which are by no means unique to the Middle Eastern Department, and point to the danger of pursuing budgetary consolidation in isolation from its adverse impact on the staff or the membership.

Having said this, it is important to avoid giving the impression that budgetary constraints are applicable to the Fund or that cost effectiveness is a second-order priority when it comes to the allocation of internal resources. In this regard, comparing the Fund's performance with that of other multilateral organizations could instill a dangerous sense of complacency.

The downsizing in the authorized staffing levels for fiscal year 1997--which represents a small increase in effective staffing, owing to the full year effect of filling vacancies in fiscal year 1996, and additional productivity gains combined with some selective scaling-down of targeted activities--constitutes a reasonable but challenging compromise to deal with the immediate demands on the institution. Such a stance should serve to reduce the extent of defused responsibilities throughout the Fund, for example in the area of surveillance over capital movements or the involvement of functional departments, other than the Policy Development and Review Department, in program reviews and evaluations at the expense of requested technical assistance and to move to more uniform personnel policies, such as in the area of training.

It would be helpful for fiscal year 1997 to integrate more fully into the budgetary process the salary review, which represents 70 percent of overall budgetary outlays, and changes in the benefit package, including projected contributions by the Fund to the Staff Retirement Plan, which seems tied to bull and bear market cycles.

With respect to financial year 1998/99, we recognize the difficulty of predicting at this juncture the Fund's future resource needs. A rigid orientation of the budget to specific periods in the face of significant changes and across-the-board cuts in staffing would be undesirable for the Fund. In this regard, an SDR-based budget, as suggested by Mr. Schoenberg, deserves further consideration. Nevertheless, we would have difficulty accepting any proposal that would deviate from the medium-term framework for budgetary decision making or that would abandon the notion of consolidation.

It will be important to ensure that progress on the issue of devolved budgeting is accompanied by adequate safeguards to ensure that consistent personnel policies and standards of quality and timeliness are observed across organizational units. The effectiveness of any budgetary procedure is crucially dependent on this aspect, and should be part of the terms of reference of the Office of Internal Audit.

Mr. Wei made the following statement:

At the outset, I would like to recall that two years ago when we indicated our support for the Managing Director's proposal that the period 1995-97 be one of budgetary consolidation, we made it very clear that the capability of the Fund to fulfill its responsibilities as mandated by the Articles should not be weakened. Similarly, we expressed serious concerns as to whether it would be possible for this institution to have no increase in staff resources without jeopardizing its capacity to respond quickly to the demands of member countries, in particular in circumstances when a member is in urgent need of Fund assistance. In dealing with a Mexican-type crisis, the Fund should be able to respond immediately by sending mission to the member country to contain the crisis. I am wondering whether the staff could give us an estimation as to how many additional staff resources have been used in handling the Mexican program or the Russian program given the complexities and intensities of the programs. In the case of Russia, the staff is required to monitor closely the implementation of the program and provide the Board with its reviews on a monthly basis. While we have no objection to the strengthened procedures which serve the purpose of securing the Fund's financial assets, the point is that such procedures require more staff resources.

In reading the Managing Director's memorandum on the budgetary outlook over the next three years, like Mr. Shaalan, Mrs. Cheong, and many others, I feel that a number of the Fund's priority functions would be damaged if an over stringent budget, which has, unfortunately, been the case for financial year 1996, were to be imposed over the following years. Like Mr. Shaalan, I am very skeptical about the wisdom of an across-the-board budget cuts approach. In this regard, Mrs. Cheong raises a very important question on the approach the Fund is taking in handling its budget. I fully support her proposed approach, and I quote "This bottom-up approach would provide a better opportunity to decide on priority and non-priority areas." It is the Board which should make decisions as to where and how much should be cut. Otherwise, as indicated in Mr. Shaalan's and Mrs. Cheong's statements many important activities in either the Middle Eastern, South East Asia and Pacific, and Central Asia Departments would be cut. They and I do not agree with the cuts. Other Executive Directors do not accept the cuts on the activities of member countries, especially the developing countries they are representing. On the countries in transition, the Managing Director is hoping that some reduction in the workload associated with these countries should be possible in a year or two as their adjustment programs begin to produce meaningful and lasting changes. I wish those representing these countries and the staff could give us their estimation on this issue. It seems to me that even when all Fund programs in these countries have been successfully implemented, there will still be strong demands from them on receiving Fund technical assistance and training.

I join many others in emphasizing the importance of the Fund's technical assistance to member countries, particularly to non-program developing countries. Technical assistance has served as an important channel between these countries and the Fund in the sense that the Fund is able, through the provision of technical assistance, to understand the various important economic issues. Any cut in Fund technical assistance will have negative consequence for the cooperation between the recipient countries and the Fund, as well as for Fund surveillance. In this context we appreciate the generous contributions made by the Japanese government in supporting the Fund's technical assistance. At the same time, like many other Directors, I am opposed to the proposal to charge fees to technical assistance recipient countries. In my view, the discussion of this issue is a low priority on the Board agenda for the coming year.

With these general remarks, let me touch briefly on some specific issues.

On external training, we appreciate very much that the Fund, through the IMF Institute, the Joint Vienna Institute, and other channels has provided many training opportunities to the officials from developing countries, including China and the countries in transition. My authorities especially appreciate that the Introductory courses, under the Japan-IMF Scholarship Program in Asia has been conducted in China. We believe that, given the continuously increasing demand, consideration should be given to add certain staff resources in this area in coming years.

On the activities of the Bureau of Language Services, first of all, my authorities very much appreciate the top quality service given in terms of the Chinese/English translations. As indicated in the background paper, translations into Chinese rose from 250,000 words in financial year 1994 to 1.1 million words in financial year 1995. This increasing trend in the Chinese workload will continue, mainly due to the increased technical assistance in China in the coming years. The other factor being that the Fund-Bank annual meeting will take place in Hong Kong in 1997. Moreover, given the importance of the data and the high quality of the Fund's statistical publications, I would strongly encourage BLS to translate the IFS into Chinese as early as possible.

In view of this, I believe that creating one additional Chinese regular staff position is justified in order to accommodate the heavy workload. As indicated in the paper, in financial year 1995 the ratio of freelance translation to total output for Chinese is 45 percent. While I believe that the quality of the freelance translation is equally good as done by the regular staff, I would say that, in terms of costs and other considerations, it would be better to increase the one regular staff member to two rather than contracting out 45 percent of the total workload.

Finally, while we pay great attention to budget discipline, however, taking into account the increased workload in coming years, which has been well presented in your memorandum, and the fact that the staff has already been overburdened, I find it very difficult to support your proposed budget for financial year 1997, namely, a reduction of 10 staff years.

Ms. Lissakers asked whether the staff could comment on the precise cost of translations.

Mr. Barro Chambrier made the following statement:

We commend the management and staff for their comprehensive budgetary approach. This has helped to meet the growing demands by the membership on the institution, while responding adequately and timely to the crisis cases, without endangering its financial integrity. However, with the rapid expansion of the Fund responsibilities in the global economy, including the need to strengthen further its surveillance, the Fund's priorities should be clearly defined, in order to persistently allocate its resources in a consistent manner. At the same time, it would be critical to keep the workload at a sustainable level.

In this context, this budgetary outlook exercise gives an added opportunity to assess the extend to which the orientation of the Budget would help to better address the challenges ahead. To this end, I would like to make the following observations.

First, there are indications that the Fund is operating at close to its maximum capacity. I agree with Mr. Shaalan and other Directors that the pursuit of the budgetary consolidation should not be detrimental to the quality and the effectiveness of the institution. Further downsizing in the staff level should thus require a careful consideration. The efforts being made for training, re-deployment of staff and the introduction of new technologies, would certainly contribute to ease the work pressure in the Fund, but these commendable measures will take some time to produce the expected gains.

Second, technical assistance will remain an invaluable input for many country members, specially for those in the process of transforming their economies or dealing with growing capital markets. The Fund should, therefore, continue to play a vital role in these countries. As other Directors, we are concerned that there has been considerable delays in responding to the request of some country members for technical assistance. In that spirit the resources allocated to Fund's technical assistance to low-income/ESAF-eligible countries must be carefully considered. The imposition of technical assistance, in the context of tight financial constraint in low-income countries, could lead to considerable delays in requesting Fund advice, even in critical areas where swift actions would otherwise be undertaken. I agree with Mrs. Cheong that this will not serve the spirit and the purpose of the Fund. Still on this subject, this chair would like to commend the Japanese authorities for their funding for technical assistance.

Third, through the Fund's surveillance exercise, many developing countries, have shown large deficiencies in the financial and economic data, as well as long delays in data communication to the Fund. In this regard, the area departments should be provided adequate means, in order to execute effectively their missions in these countries.

More specifically, it is expected that a record number of Fund-supported programs will be approved in financial year 1997 for the sub-Saharan African region. In this context, the projected resource of the African Department does not seem realistic, if we consider that policy development and research, statistics and information activities, as well as country-specific activities, including regional integration, will put additional pressure on the staff.

With the large number of program/intensive cases, the Fund should also devote additional efforts to develop a medium term framework, in order to ensure that the Fund-supported programs will lead to a lastingly stable macroeconomic environment. We wonder whether additional resources could be allocated accordingly.

Fourth, the services of the Bureau of Language Services are essential for some country members, including countries of the former Soviet Union and those in our constituency. I would thus recommend that adequate resources be devoted to the Bureau of Language services in order to maintain the high quality of professional services. We wonder whether reliance on free-lance translators could not hamper the quality of these services.

Fifth, during the Board discussion on the administrative and capital budget for financial year 1996, concerns were expressed on the nationality distribution of recruits in the Fund. For follow up, we would encourage management to pay due regard to these issues.

Finally, we are in broad agreement with the management budgetary orientation. We should, however, pay more attention to the efficient utilization and mobility of the staff and ensure that the level of the workload is sustainable.

Ms. Srejber made the following statement:

Several of the factors explaining the present heavy workload will continue to exist, and most probably also in the future place a heavy burden on the staff. Unless we are able to give less priority to some tasks--and, as Mr. Evans and others have done, I admit that we have not been particularly clever in this respect as we tend to ask for "more of everything" and never ask for "less of something"--we will be faced with a continuous demand for more resources. And it is the Board's task to weigh the demand for more resources against the need for adding new tasks and/or improved quality standards.

Of course it is cumbersome and difficult to make these priorities. In the short run, it is always tempting to be "nice" and give higher priority to certain objectives, and ask for higher output from the staff, like we recently did for surveillance and provision of data, and in response accept that this increased demand must be met by new allocation of resources. By doing so, we, however, fail to meet our obligation to produce the required services for our members as efficiently as possible. I believe that every organization needs to forcefully--and on a continuous basis--seek areas that deserve less priority, look for procedures and routines that can be done more efficiently, thus always be looking for minimizing resource use. We should ask ourselves not only whether we do the right things, but also whether we perform our tasks in the right way.

I join other speakers in pointing to that our tools for carrying out such a process is not as good as could be wished for at present and the consequences have been well described by Ms. Lissakers: we gain weight in periods of crises or new challenges but we do not lose weight in periods in between.

Thus, also I want to emphasize the need for further improvements in the budget process itself. Not surprisingly I agree with Mr. Evans in his five guidelines. Without a modern and timely budgeting and accounting system where data on the use of resources and cost of various functions are presented to the Executive Board on a regular basis, I find it difficult to assess the benefit of one function or activity against another. A proper budgeting system plays a critical role in the budget process. Within the framework of a strict budgeting and control system with clear targets and clear limits for decision making on various levels of the organization, decisions could be decentralized for the use of most resources in order to induce rationalization and increase flexibility in the organization. We need a modern budget and accounting system that covers all administrative items including salaries and all employment costs, and replaces the present labor intensive and costly system.

The modalities of such a system and of improved budget procedures are probably not best designed in the Board, but could be discussed in the Budget Committee. I know that the establishment of such a system is in the process, but I would like to emphasize that I think this should be done decisively and with a less extended and open-ended time plan than presented to us in the Budget Committee.

Given the deficiencies of the present budget procedures and of the budgeting and accounting system, we have to base the assessments this time on present methods:

The Fund has, since the late 1980's been through a period of rapid growth both measured in staff years and in U.S. dollars. One of the main factors behind this has been the increase in the number of member countries, and the tasks associated with that. Even if several important tasks still require more resources, after a period of rapid growth, the potential for productivity gains is good. Newly employed staff will, when gaining experience, increase their productivity. It should now be possible for us to get productivity gains after the de facto increase of almost 50 staff years in 1995 on top of almost 50 in 1994. Thus, I would suggest that we keep an eye on the possibility of some scaling back in activity in areas where it is feasible in the coming years. The fact that it is difficult to predict the optimal output level for a long period for an institution like this is not a strong argument for not trying. Hence, like many other speakers, I cannot go along with the proposal to postpone any decision on the level of budgetary resources for financial year 1998 and financial year 1999. The guidelines or targets that we establish should not serve as a straight jacket that would unduly limit our ability to respond to unforseen events should they emerge, but they should establish some limits that serve as basis for planning and decision on a micro level.

For the next year I am, however, not sure that these productivity gains, that we should be able to see when formerly new staff get warmed up, could counteract a total downsizing of 40 authorized staff years as proposed in option one. Such an alternative would, if we should get a higher output in surveillance and related areas, need to be supplemented by transfer of resources from activities like, for example, statistics, information, administrative support and possibly external training into the high priority surveillance area.

In this context, I would like to give a short remark on the use of resources for "Information, liaison, support departments and other". The absolute number of staff year has, during the recent growth period, been held quite stable, indicating that an rationalization might have taken place in these areas. The relative size of "support" has thus fallen from 37.5 percent in 1991 to 30.9 percent in 1995. Such numbers, based on staff years and not on dollars, do not give a very good picture of the actual use of resources for "support and other." In addition, the Fund uses vendors which I understand are not included in Table 2. I am certainly not opposed to the use of vendors, but as long as we do not know the sum of authorized staff years in the Fund and man years bought from outside the Fund, and count in the budget, an assessment of what we get for our money is quite difficult. Anyhow, even with these reservations and with due regard for difficulties to compare institutions, a comparison of the provided figures with relevant figures in other institutions with high service-level, like some central banks I know well, leads me to the conclusion that our use of support-resources seems high. In other institutions, the relative share of support resources has been decreasing due to efficiency gains of computerization. True, the relative share of own staff has decreased also in the Fund but still seems to be high. I thus suspect that administration and other support activities is an area where we could make efficiency gains even if we keep the present service level--and maybe also the service level could be re-evaluated.

To conclude, even while the material before us today does not make it possible for us to make an insightful assessment of the optimal input and output level, I would like to reiterate that I certainly am in favor of consolidation. This should be established as a firm medium-term target. For the next year I would accept that additional resources are needed in some areas and I suggest that the management when preparing the detailed budget, continue to aim for some combination of option one and three as proposed in today's paper, where a reduction by ten authorized staff years is suggested.

Mr. Daïri made the following statement:

The principal challenge in assessing the medium-term budgetary outlook is to reconcile the minimal resource levels of the Fund with the increased work demands on the institution. In evaluating different scenarios for an optimal solution, it is important to have precise measures for the valuation of output as well as clearly defined links between resources and output. It is evident that, in the case of the Fund, the evaluation of output is largely a matter of judgment, and the established links between output and resources are defined only vaguely. Hence, the budgetary process can hardly be seen as the outcome of an articulate correspondence between output and resources. This being said, there is a tendency to take the firm view that a top-down or a bottom-up approach has to be adopted for efficient allocation of resources. It is clear that the Fund cannot be seen as an entirely demand-driven institution. At the same time, a strict top-down view would hinder the Fund's ability to respond to unanticipated events.

Therefore, we must consider the resource allocation and budgetary process in the Fund as one in which new demands should constantly be viewed against the availability of existing resources. Through this process, it should be possible to find a second-best solution for the allocation of resources. We all recognize how difficult it is for the management to meet the dual objectives of budgetary consolidation and increased demands. In the circumstances, we should at the outset adopt a consolidated budgetary strategy in the medium term, which would allow reviews to take into account the evolving work load. This procedure would provide the Fund an opportunity to reap productivity gains through a continuous evaluation of work priorities, the need for resources, and the introduction of new technology. In this context, I can support management's proposal.

Maintaining a high-quality and well-motivated staff should be at the core of the budget exercise. I would support placing limits on the size of the staff, rather than on the well-established and justified compensation system. More generally, the ongoing strengthening of surveillance, if successfully conducted, and the progress in adjustment and reform in many countries, should help to reduce the need for Fund services over the medium term. Of course, the reduced need for services is in terms of quantity, not quality. The globalization process, enhanced openness, and the data publication standards should also reduce the need for Fund surveillance, which will be replaced by market surveillance. The universal recognition of the benefits of sound policies should also have the same effect.

Better coordination with other international and regional organizations should help to reduce the Fund's work, as it has been observed, for example, in some research activities. Better distribution of work between missions, staff at headquarters, and resident representatives, where applicable, can also improve efficiency of resource allocation.

The prioritization of work should take place more in the evaluation of objectives within each function than in the classification of functions against one another. I do not think that the Fund's work can be easily divided between high-priority functions and low-priority functions. In fact, all area and functional departments contribute to the fulfillment of the Fund's mandate. Nevertheless, there are probably areas where more productivity gains could be achieved through the use of more market-oriented technology, and that might help to release staff resources for other functions.

Also with respect to prioritization, I join other Directors in emphasizing the importance of technical assistance. However, like Mrs. Cheong, I cannot support the idea of charging recipient member countries for technical assistance. Technical assistance is closely related to Fund surveillance and financial assistance, and it is hardly possible to disentangle these two activities in some instances. Also, some of the research activities conducted in the Fund, including in the context of the World Economic Outlook, can easily be classified as technical assistance. Charging developing countries for technical assistance may result in a reduction of capacity building, and also discourage ownership of sound policies.

As to the deployment of positions to achieve economies in fiscal year 1997, I share the doubts expressed by Mr. Shaalan about the merits of across-the-board budget cuts. Even the allocation of productivity discounts to justify across-the-board budget cuts is not advisable in an environment that is changing and where there is almost no spare capacity. We strongly support Mr. Shaalan's remarks on the increased work load in the Middle Eastern Department. Recognizing that other area departments may have similar problems, I recommend that the redeployment process be carried out through a clear definition of functions, to be discussed by the Board if needed.

In conclusion, I support keeping the Fund as lean, as possible, but only to the extent that it will not damage its ability to meet its core objectives in an efficient manner.

Mr. Geethakrishnan made the following statement:

Some of the chairs earlier had compared the Fund budget to the country budget and tried to draw lessons. I myself had done so on earlier occasions. Once, I do remember saying that if the Fund can impress upon India to reduce its food subsidy, why can't following the dictum, "Charity begins at home," we reduce the cafeteria subsidy in the Fund? I do not know if it is because of my suggestion--I am inclined to take credit for it--but these days when I go to the executive dining room, I find the charges are much more than what it was last year. As a result of my comparison the subsidy has been eliminated.

Maybe the comparison of the country budget has proved to be good in this case. But, I would not carry it beyond that point. There are very major differences between the budget of a country and the budget of the Fund. To start with, the countries are in the business of collecting money as well as spending. Normally, we do not get excited about it, about either the level of collection, or the level of expenditure, unless, of course, it becomes excessive thus impeding other activities. We are basically interested in the difference between the two, whether you call it a fiscal balance, budget balance, revenue balance, or anything else, including the primary balance. If it becomes excessive, we get worried about it.

In the case of the Fund, it so happens that we are basically an expenditure-oriented organization. Our revenues, which are independent, are very little, and whatever expenditure is incurred, it is borne by the membership through the burden sharing, either by way of charges or lack of remuneration. So that comparison is not on all fours.

The second reason why the comparison is not on all fours is, that a country government has a vast range of activity, as Mr. Clark ably pointed out earlier, so it becomes a little easy to pick and choose, emphasize certain items and cut out something else. We are, on the other hand, a very, very small organization with a limited range of activities. So, our scope for picking and choosing, cutting out something and taking up something else, that is very limited. So I would not like to carry this analogy of our budget and the government budgets beyond that point. It is okay up to a point.

In our case, basically, the emphasis is to see that the expenditure is kept under control, so that the impact on the creditors as well as the debtors, by way of the burden sharing arrangement, is kept to a minimum. In this sense, we do not have the concept of deficit. As we cannot introduce the concept of fiscal deficit or primary deficit in our organization, we try to put in other phrases. We call it budget consolidation, zero budget in nominal terms, or a zero budget in real terms, or we even set a percentage reduction over the three years. We need to be very careful in this concept. We should not put the cart before the horse and start with the idea that we need to have such and such a target in the budget. If, for instance, we decide that, say, five years from now our annual operating expenditure shall be 25 percent or 30 percent less in real terms than now, well, if that is the objective, we can find a solution. Mr. Ouattara and I were discussing during lunchtime, we decided that, maybe the Fund could shift its Headquarters to Ivory Coast or India, where the cost of living is very less, we will end up with a 25 percent saving. That is not the objective. Likewise, if it is decided that our primary objective is a cost reduction, we may very well decide that the staff compensation, instead of being increased by 3.5 percent or 4 percent, in keeping with the rise in prices, should in fact be reduced by 10 or 15 percent. Well, you could achieve the results. Many of those from the developed countries may leave the Fund for better pastures. We may be attracting a large number of equally competent people, but from the developing countries. Whereas, Mr. Mesaki may want to suggest that the salary compensation, in fact, should be 25 percent higher if you are to attract more Japanese, trained Japanese because he genuinely feels that the compensation levels are much higher in Japan than here. We cannot carry this to an extreme. For instance, if we decide on a budget consolidation in real terms, then many chairs can argue, let us aim at the expenditure on technical assistance, being brought down to zero on a net basis, either by charging or by getting bilateral donations. Equally, many developing country chairs can very well argue that on surveillance, where many feel that it is unevenly impacting, more on the program countries than on the developed countries, we could very well suggest a dilution of the surveillance standards. Luckily for us, whenever the Board discusses each of these items, we take good, sensible, correct decisions, whether it is on salary compensation, or on surveillance, or on data publication, we take decisions that are in the best interest of this organization. Maybe these things lead to additional manpower deployment or additional expenditure. Then, these things become inputs to the budget where we will have to take a decision.

So I will not like to start with the phrase budget consolidation, except as a kind of a broad philosophy. I would not like to put down any target saying we should aim at a zero growth, either in real terms or in nominal terms, or there should be a reduction. Our basic job is, as I said earlier, we are in a small organization with a limited range of activities. The Board looks into each one of these activities, comes up with what is the best to maximize the quality of the output. Having done that, we determine what are the resources. We feed it into the budget process. There, we decide at the same time, since our objective is also to reduce the costs for all the members, that we need to be tightfisted. In fact, if we are looking for a slogan, it is not budget consolidation, but tightfistedness that should be the slogan. Another word is being mean. I will not use it. Let us be tightfisted.

We have been tightfisted in the past. For instance, we have responded ably to challenges, such as the break up of the former Soviet Union, which called for more staff deployment in European and East European countries. We did increase the staff by 22 percent in the years 1990 to 1993. That does not mean we continued to be extravagant in the subsequent years. We are back on the consolidation phase where we are trying to be tightfisted. We have kept things under control. Basically, my approach would be that whatever we want to do in terms of activities, we discuss it separately, aim at what is best for this institution in terms of quality improvement. This may call for a certain increase in the resources or a decrease in resources.

Then, as I pointed out earlier, it is the right of the Board to throw it into the lap of the management that we want more staff for surveillance, more for standard data and publication, but still you should try and keep the budget lean. And it is equally the responsibility of the management, even as it is their prerogative to come up with answers to that. Let me explain it.

It is only the management which is in touch with the staff and all the activities on a day-to-day basis. The management is in a position to come up with suggestions, where is the extra fat?; what are the posts that are unnecessary?; who are the staff that are passengers; and where are the cuts that can be made? This knowledge I do not think the Board can arrogate to itself. We will be failing miserably. We do not really know. We interact with the staff who deal with our country. Beyond that, none of us have any detailed knowledge. Maybe some of us, persons like Mr. Shaalan, who have very intense experience in the Fund are in a position to make suggestions, but I would not presume it for the Board as a whole.

It is the right and the responsibility of the management to come up with such suggestions. The Board would like to say, be tightfisted. The Board would like to say, we want the quality to be improved in the following items, and at the same time we do not want, under the burden sharing arrangement, a larger burden to be placed on the creditors or debtors. We would then expect the management, supported by the various Directors and the division chiefs, who have a very detailed knowledge of the various activities in the staff, to come up with suggestions as to where the fat lies, what should be cut, what activities should be abridged. I would not like to presume to have that knowledge. I would like to leave that responsibility totally to the management.

In the scenario for the next three years, the Managing Director's memorandum has given three options, whether we should cut 40 posts or 67 posts, or add 25, or cut only 10. I will not endorse any of these, if the numbers are arbitrarily chosen. I do not want a cut to be made for the sake of a cut. I would like to be very clear on this. If the cut of 10, 40, 25, or 67 posts is merely with a view to satisfying some budget target, I do not endorse it. On the other hand, if the management, based on the detailed appraisal, should come tomorrow to the Board and say, we have found a thousand positions to be surplus, I would gladly endorse it. On the other hand, equally, if the management should come back and say, we do not have a surplus, we need to add 25 posts, I would gladly endorse it. The point that I am making is, this responsibility will have to be undertaken by the management, and I would like to accept their word for it. It should not be an arbitrary decision. If it is arbitrary, we would end up with a kind of problems that Mrs. Cheong or Mr. Prader had highlighted in their earlier interventions. I do not want that to happen.

Basically, as I said, our activities are few. We should be able to focus our attention on these activities. We are an international organization with a staff drawn from the various countries. We have some restrictions. We are not very free agents. You cannot, tomorrow, decide that all the staff will be recruited only from the developing countries. We need to take note of this.

I can only quote what Mrs. Latifah Cheong was mentioning earlier to me. She said, look, it is nice to say that we should all be totally lean. But there is some advantage in having some fat. She gave four reasons. One, some fat makes us look a little better and rounded and more attractive. That is point number one. Second, some fat makes us respond to a cries for reduction of fat. You are immediately able to then say, if you want a reduction of fat, here is some fat that I have reduced. Third, some fat enables you to respond to emergencies. If you are hard pressed for time, if you want to put an extra six people on Mexico or seven people on Bosnia, you are able to draw from this fat. And lastly, no organization, no man is perfect. We are all imperfect. Whatever you aim at, you will end up with some fat. So no point in feeling bad about it.

So to conclude, I would endorse the Managing Director's budget proposals for the current year's revised budget and the 1997 budget, and the medium-term budget. I would not go beyond what you have indicated as feasible. Basically, the responsibility is yours. The call from the Board, as I see it, is, we would insist on a very high-quality delivery. We would also insist on your being extremely tightfisted. And we would expect the management, which are aware of all the activities, which is aware of what positions are surplus, what activities could be abridged or cut, we would expect the management to review it on a continuing basis and come up to us wherever they find there is scope for reduction. I would not like to say that in the year 1998 or 1999 we are going to have a 5 percent cut or a 10 percent cut. Far from it. We may end up with 10 percent increase in expenditure. So I would rather play it by ear, as things go along.

As to so-called dollar budgeting, coming from India where our accounting is done in rupees, I thought that the cry was that we should do the budgeting in dollars, until I discovered that in any case it is done in dollars in the United States. Then I found it is a euphemism. You work out a total budget in money terms for the financial, technical and manpower resources, and give total flexibility to the Department Head or Division Chief. I find this suggestion totally paradoxical, like blowing hot and cold at the same time. Because the Board at the one level wants to get its teeth into each and every activity through the budget committee and the budget process. We want to tell the management, do this better, do that better, please bring it up in the name of transparency. Having insisted on it on one hand, we at the same time are also saying, delegate it to the division chiefs or

Directors, whatever they want. If they want to dispense with all the permanent staff so they can go and spend it on travel, we seem to believe they should do that. I think the priority lies in the Board understanding better what are its own priorities, putting it down clearly, down to the last detail, and then tell the staff, look, these are the set of priorities that we want to be delivered; and these are the mix of resources that we want to be used toward this end. Here, of course, the management would say, this is our responsibility, while the Board would like to assert its supremacy. That is the dialogue that is going on. Once it is put down, and that concept goes down the line to the 2,750 staff, then I would delegate responsibility for incurring the particular expenditure or undertaking that activity. I would not like to put the cart before the horse and say, let us delegate it first and then ask questions, because the delegation theoretically could result, if all the Directors act in unison, in totally subverting whatever priorities the Board wants. So I do not think we are still ready for that. I have a serious question mark on the dollar budgeting. Since the cry comes from the so-called experience in the Bank, I would, first of all, like to know what is the dollar budgeting practice of the Bank, how successful it is, and how relevant it is to us.

My last point is on transparency. When several of us raise the question of transparency, it is not because we feel there is some hanky panky, that something is being done behind our back. No. The budget itself is a subject very few of us understand. The added complication is the Fundese, the language in which the budget is put across in. In the last 15 months or so, the transparency has increased, the very free and frank discussion we have had, in the Budget Committee, has enabled us, the Board of Directors as a group, to understand the process better. So when we call for transparency, the way I understand it is, we must continue this process better. We must try to convey clearly to everybody in simple English, simple arithmetic, this is our budget, this is what we are doing. Today, perhaps, judging from the demand for transparency from some of the chairs, this is not taking place. I think we should pursue the efforts to make our budget more open in terms of arithmetic and language so that everybody understands.

Ms. Lissakers remarked that, in light of the proposed budget of $479 million for financial year 1997, it was important to consider how the necessary funding would be obtained. It would be very difficult to explain to the U.S. Congress that the Fund was a demand-driven institution and, therefore, that budget constraints should not be applied to it.

Mr. Evans said that he agreed with Ms. Lissakers. In his opening statement, he had not outlined specific areas in which cuts could be made. Nevertheless, his office had prepared a list of activities in the Fund that could be given lower priority than at present. He wondered whether the management and staff would like members of the Board to put forward suggestions pointing to areas where cuts could be made.

The Chairman responded that such suggestions were sought from members of the Board at the biannual discussions on the work program. As those discussions showed, the Board seemed to find it much easier to add to the tasks of the institution than to cut them. It was always difficult to make budget cuts in any institution. However, it was even more difficult in the Fund, because it had always followed very prudent policies to guard against overstaffing, even in particularly hectic periods. It had also devoted a great deal of attention to the redistribution of staff from lower-priority to high-priority tasks. Thus, it would be very difficult to make further cuts in the level of staffing at the present stage without sacrificing some of the services currently provided to members. Moreover, even if some members identified certain services as "low priority," it would be difficult to garner sufficient support from other members to cut them.

Nevertheless, he would welcome suggestions by members of the Board on where cuts could be made and where productivity could be increased, such as through improved working methods, the Chairman said.

Mr. Clark commented that he could support most of Mr. Geethakrishnan's remarks for the current discussion, in particular those regarding the respective roles of management and the Board in the budgetary process and the advantages of maintaining some "fat" in the organization. However, it should be noted that his opening statement had not been based only on the experience of Canada; rather it was based on three propositions that applied to all organizations. First, it was not possible for any organization to meet all justifiable demands. Second, when budgets were constrained in a credible way, well-run organizations could adapt; indeed, they could even thrive. Third, any credible mechanism to impose a hard budget constraint was likely be seen as arbitrary, but it would still tend to inspire greater creativity, innovation, and prioritization.

Against that background, the support of his Canadian authorities for a zero nominal increase in the budget should not be misinterpreted as any lack of support for the work of the Fund, Mr. Clark stated.

Mr. Petrie noted that Mr. Geethakrishnan's comments seemed to imply that the view expressed by some Directors that the Board should take on a larger role in overseeing the budget process, while giving management more flexibility in implementing the budget, was inconsistent. On the contrary, that view was meant to suggest an alternative framework for approaching the budgetary process. Under the current system, the Board approved the budget on the basis on inputs, in terms of salaries, travel allowances, and other expenditures, and, in so doing, the Board placed constraints on the ability of the management to apply those inputs flexibly in producing the full range of services desired by members. The alternative approach suggested by some Directors would ask the Board to focus on outputs, or the actual services desired, and allow the staff and the management greater flexibility in determining how those outputs were produced.

As Mr. Geethakrishnan had noted, such an alternative approach was not without risk, Mr. Petrie stated. In particular, there were issues to be addressed concerning how information related to staffing and personnel management would be handled, and how the overall performance of the Fund could be assessed. In that connection, it clearly would not be possible to change the budgetary process in a single step. Nevertheless, such an approach would address some of the other concerns raised by Mr. Geethakrishnan with respect to avoiding micromanagement.

Mr. Berrizbeitia stated that, as most Directors would agree, the Fund was a lean and effective organization that was committed to providing the highest quality services to members. In the circumstances, further budget cuts could be made only by reducing either the quantity or the quality of services. His chair could not support such cuts. Although Mr. Clark and Mr. Evans had suggested that a reduction of resources would enhance the focus of the organization on core responsibilities and give rise to innovative work practices, he was skeptical about whether any more efficiency could be gained in an institution that was already lean. If the consensus among Directors was to reduce the quantity or the quality of services provided to members, such decisions would need to be taken by the Board, not management. Moreover, the Board should take full responsibility for such decisions, and it should call on all members of the Board, both individually and collectively, to come to a view on which services should be reduced or eliminated.

Mrs. Cheong stated that, although it was important for any organization to be relatively lean, there was also a need to have some extra resources to address emergencies and to ensure effectiveness over the longer term. For example, when her own country had reduced its public sector work force to a minimum, government agencies had not been able to release staff for training. As a result, personnel had not been able to keep abreast of the latest technological and other developments, and efficiency was lost over time. The costs of that consolidation effort--in terms of lost output over time--had been greater than would have been the case had a smaller reduction of staff been agreed at the outset.

Mr. Geethakrishnan noted that the Fund had always responded well to the various challenges that had arisen in the past. At the same time, it had always maintained a good track record as a lean and effective organization. In the light of that track record, the management of the Fund should be given a free hand in determining what, if any, reductions should be made in the level of staffing or in the overall budget. In any organization with as many as 2,750 staff, such reductions were likely possible. For example, there might be scope for reducing or eliminating the subsidy applied to the staff cafeteria. However, those kinds of decisions could well be left to the management of the Fund. His chair could not agree to any reductions that would affect the quality of Fund surveillance or technical assistance, or in the support provided to members in designing and implementing adjustment programs.

Mr. Autheman made the following statement:

> I agree with Mr. Clark that the budget process is an exercise in arbitrariness. My yardstick is the size of the Fund staff, which is approaching its ceiling of 3,000 staff. We have already reached 2,966. If the size of the staff continues to grow, communications will suffer, and the organization will lose a great deal in terms of its effectiveness. Therefore, I prefer option 1. As some Directors may recall, I criticized the decision to move all Fund members to the 12-month consultation cycle.
>
> In the circumstances, we will have to live with the Managing Director's proposal to stabilize the size of the staff, instead of reducing it slightly. I can accept such an agreement as long as the total size of the staff stays under the maximum of 3,000.
>
> I do not favor dollar budgeting. Under the current system, at least the size of the staff is clear. If dollar budgeting were introduced, that would no longer be the case.

The Director of the Office of Budget and Planning said that the total costs of the Bureau of Language Services amounted to approximately $17 million a year, or about 3.6 percent of the administrative budget. That estimate covered approximately 120 staff years, including benefits, as well as overhead costs, such as for office space and technology.

There had been some increase in the utilization of leave over the past year compared with previous years, the Director stated. However, the number of staff travelling in excess of 50 business days per year had increased over the past year or two, although the distribution of staff travelling varied, particularly for staff working on countries undergoing Fund-supported programs. According to the budget reporting system, which recognized both paid and unpaid overtime, the average number of hours worked per week had risen over recent years. While the average work week was a little over 40 hours per week for staff in the lower grades, at say A1-A3, it had risen to over 50 hours per week for staff in the higher grade levels. Of course there were variations among grades and Departments. In addition, there might be some underreporting of unpaid overtime on the part of the staff.

As some Directors had noted, there was more administrative support in the Fund than in some other organizations, the Director commented. That was partly attributable to the fact that the Fund worked in several different languages, unlike many other institutions and national administrations. It was also partly attributable to the international character of the Fund staff, which required somewhat more administrative support than the staff of other organizations, which were more homogeneous.

The staff would consider the timing of the staff compensation exercise with a view to determining whether it could be better coordinated with the Board's consideration of the administrative and capital budgets, the Director of the Office of Budget and Planning said.

The Chairman made the following concluding remarks:

This has been a productive discussion. I am grateful that you have noted the significant progress that has been made in the evolution of our budget process, and we take note of the various aspects that Directors have pointed out as possible avenues for further improvement. We, too, have these points in mind, and will certainly look into them in the coming months.

Although a variety of views were put forward, there seems to be a general convergence around the proposal put forward in my memorandum (EBAP/95/100, 11/29/95), and we will proceed on this basis, of course, taking into account the various comments and suggestions you have made. The issue of the timing of the staff compensation exercise and its relationship to the medium-term budgetary outlook, in particular, requires careful consideration. We also need to consider the interesting suggestions of Mr. Schoenberg. I shall ask Mr. Ouattara to look into these matters.

With regard to our technical assistance efforts, let me extend again our appreciation to Mr. Mesaki for the continuing efforts of his authorities to support us in this endeavor. As to the issue of country contributions for technical assistance, I note that many of you are not fully satisfied with the present state of affairs, and we will look at this matter again in due course. At the present stage, I, personally, am more concerned about the complaints we have received from a number of countries about the slowness with which we respond to their requests for technical assistance. I hasten to add that very frequently the countries that complain about our slowness to provide technical assistance are also the ones that are slow to implement our technical assistance recommendations. I would like to urge countries to take more seriously the recommendations of our technical assistance missions. There are cases in which truly major mistakes could have been avoided and the countries involved would have been in much better shape today had they accepted the advice repeatedly put forward by our staff. So we need to look at both of these issues in re-evaluating technical assistance, of course, having also in mind the clear linkage between the progress made with respect to technical assistance and that made under Fund-supported programs, in particular in those countries eligible to use ESAF resources.

We have also taken note of your comments on the need to make the medium-term budgetary outlook exercise as precise as possible. In that respect, I can reaffirm our intention to supply the Board with the full complement of data and projections needed to make the medium-term budgetary outlook exercise as relevant as possible.

There is a generally shared concern that we must preserve, and indeed enhance, our intellectual capital. As I stated in my memorandum for the current discussion, this is the Fund's greatest asset. We are fully committed to protecting and enlarging it, because the credibility and the usefulness of this institution to our members is via our staff. In making this point, we must also note that the excellence of our intellectual capital is not directly related to the number of staff engaged in our work. Provided that a minimum critical mass of human resources is maintained, the promotion of intellectual capital will depend on several factors: the type of issues the staff is invited to deal with; the quality and frequency of its interactions with outside research centers; and the working environment, including opportunities for career development and the level of compensation--a factor we would be prudent not to lose sight of. We will continue trying to maintain this unique asset of the Fund, and I know that I can count on this Executive Board to help us in this endeavor.

Your comments and suggestions will help guide our work in designing the administrative and capital budgets for financial year 1997.

3. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS, PROSPECTS, AND KEY POLICY ISSUES - INTERIM DISCUSSION

The Executive Directors considered a staff paper on developments, prospects, and key policy issues in international capital markets (EBS/95/196, 11/28/95).

Mr. Mohammed, speaking on behalf of Mr. Shaalan, made the following statement:

As usual the staff paper makes a valuable contribution to our knowledge of the evolving structure of international capital markets. I broadly agree with the assessment of recent financial developments and will limit my comments to the last three questions that are proposed for discussion.

On technical trading and derivative-related activities and the dollar/yen exchange rate, explaining exchange rate movements is a hazardous task. While economists generally tend to agree that economic fundamentals rather than market sentiments determine long-term currency values, there is wide disagreement on explanations of short-term movements in exchange rates.

It is difficult to ascertain whether technical trading and derivative-related activities have increased the volatility of the dollar/yen exchange rate during the first half of 1995 as the report suggests. First, it is not entirely evident from the Charts on page 6b that movements in exchange rates were excessively volatile in 1995, compared to previous years. Second, causality and feedback between movements in derivatives and the exchange rate is not clear. It would have been useful if an analysis of the mechanisms by which technical trading and derivatives-related activities are transmitted to exchange rates was included in the paper. Inadequate statistics on derivatives activities, as well as the lack of fully developed models or theories on how transactions in financial derivatives might affect the exchange rate, have left several unresolved questions. There is a need to monitor activity in derivatives to obtain accurate valuations of instruments, and to understand more fully the interaction between derivatives markets and the traditional financial markets.

On financial system problems, this chair has often expressed the view that a sound and efficient domestic banking and financial system is crucial to assure macroeconomic and financial stability. Weaknesses of financial institutions greatly magnify vulnerability to sudden shifts in market sentiments. In this respect, the staff appropriately paid attention to recent developments in the banking systems in Argentina, Brazil, and Mexico. Recent country reports discussed by the Board indicate that an increasing number of countries appear to be afflicted with weak and fragile banking systems. I would urge the Fund to conduct in-depth studies of those banking problems and particularly how they may be related to the globalization of financial markets and financial sector reforms introduced in many countries.

On the question of Japan's financial system, the authorities face a range of choices in dealing with the problems in this sector. An aggressive approach, forcing assets sales at much lower prices to quickly recapitalize the banking institutions, could provoke a sharp recession but it would also pave the way to a relatively quick recovery. This should, however, be accompanied by faster write-offs of nonperforming loans. The approach proposed may not be considered so aggressive if account is taken of the recent profit performance of the major banks. By reducing short-term interest rates, the Bank of Japan has cut the banks' cost of funds to near zero; lending rates have dropped more gradually, thereby widening the spread. Banks are also sitting on sizable profits from the appreciation in government bonds. This windfall comes on top of the recovery in Japan's stock market.

Another approach calls for a massive bail-out enabling municipalities to purchase real estate from distressed companies. Public funds thus may be used to avoid outright bank failures but these decisions should be made on a case-by-case basis rather than as a grand plan. An important unresolved problem is that of the seven housing loan corporations which appears to require significant use of public funds. However, the September fiscal stimulus package included only ¥3.2 trillion for government land purchases (World Economic Outlook, Box 1). Has this measure helped stabilize property prices? the staff views on the impact of this measure would be welcome.

With respect to the banking problem in Mexico, Standard & Poor's reported that Mexican banks were in deeper trouble due to nonperforming loans than official government figures suggested. While the authorities placed the banks' total nonperforming loans as of August at US$16.7 billion, Standard & Poor's maintained that past-due loans could well be double that amount--or in excess of 30 percent of banks' total credit portfolio. Could the staff comment on the apparent discrepancy in the reporting of nonperforming loans in Mexico.

While Mexico's banking crisis is being addressed, it isn't over yet. The Fund's experience with other countries suggests that it takes more than two years for loan portfolio problems to work themselves out once the economy begins to recover. It is not clear, as of yet, whether the Mexican economy has reached that stage. This is a factor that needs to be taken into account in addressing the fragile banking sector.

On investment flows to emerging markets, it is clear from country ratings by Moody's and Standard & Poor's that significant differences remain in access to international markets between most of the Asian and several Latin American countries. These differences are reflected in the distribution of international credit facilities among these countries. The significant differences among developing countries in accessing international markets depend on their creditworthiness as assessed by financial institutions. The bases for these assessments are well-known and encompass mainly economic performance, debt burdens, and the level of foreign exchange reserves, among other things. I would like to suggest another explanation for the more sizable flows to most Asian countries compared to Latin American countries, namely, the higher rate of domestic savings. As we know, these finance a higher proportion of a more buoyant investment level in Asia than is the case in Latin America. Other things being equal, this could make the higher savers less vulnerable to the vagaries of speculative capital flows and hence a safer haven for investment flows.

It is encouraging to note from Table 2 that syndicated credits to developing countries started to pick up in the third quarter of 1995. This development appears to have been driven largely by two factors: the manner in which some emerging countries have addressed the ripples emanating from the Mexican crisis and the interest rate differential between emerging markets and industrial countries. These factors would lead us to expect a dampening of capital flows generally to these countries were another major crisis to occur or if interest rate differentials were to narrow significantly.

Mrs. Latifah Cheong made the following statement:

The staff has produced a useful update in reviewing the performance and developments of financial markets for most of 1995. The paper has put together, in a coherent manner, the mass of information available in the financial media, including the regular OECD Financial Markets Trends reports. The real value of the report before us is that it forms the basis for the Board to evaluate the staff's perspective of the factors and broad issues underlying developments in the international capital markets and their impact on prospects for the balance of payments and growth at the level of the regional and global economies. In this respect, the scope of the paper should be expanded by linking developments in the capital market to overall economic performance to enhance its usefulness for macroeconomic management.

The financial sector is contributing an increasing share in the GDP growth, especially in emerging markets. Changes in the composition of borrowing (or lending) instruments and direct investments will impact the balance of payments flows as well as determine the sustainability of financing arrangements. The paper's analysis will have more utilitarian value to policy makers if it were to incorporate an analysis of the contribution of financial transactions in GDP growth as well as the changes in the composition of the financing of balance of payments.

Incorporation of this more analytical assessment need only be made probably, once a year, to enable the Board to evaluate implications of changes in financial market developments, not in isolation or for itself, but more for purposes of monitoring the follow-up policy work. This presentation will allow us to see the role of capital markets in the economic transformation process and their significance in GDP growth for developed and developing countries. In this sense, the analysis of capital market developments would be more useful also for surveillance at the regional level.

This chair fully agrees with the staff's conclusion that financial markets have performed well in 1995. Nevertheless, to play the devil's advocate, I would question whether the staff's assessment that "despite the increase in trading volumes and volatility ... these markets have on the whole performed well", augers well for the world economy. Some markets (foreign exchange, futures, options and derivatives) thrive on uncertainty. Exceptionally high trading volumes could be a reflection of excessive volatility arising from market perceptions of greater uncertainty in exchange rate (and interest rate) movements on the basis that existing levels are not in line with economic fundamentals. In this sense, too good a performance in international financial markets could actually be indicative of more pronounced market uncertainty over the management and direction of the global economy.

In recent months, major exchange rates have not reflected economic fundamentals. Foreign exchange interventions by monetary authorities to fight speculation and restore stability were finally effective only when undertaken suddenly, massively and multilaterally. These are conditions which are difficult to coordinate given the diverse priorities of national economic policies.

We also agree with staff that the use of derivative instruments do, to some extent, influence the market volatility. However, the use of derivatives by itself, would not entirely influence yen/U.S. dollar rates. Rather, it is the uncertainty of investors, traders and borrowers on the future levels for the currency that require them to hedge. Uncertainties also provide opportunities to speculate and arbitrage. Available instruments, like options, only make this activity less costly and consequently enhances its use. However, greater certainty on exchange rate levels which reflects economic fundamentals could reduce the volume of speculative activities.

Volatility creates high turnover leading to high financial profits accruing to financial intermediaries and, therefore, it is an important economic phenomenon that affects GDP growth. At the same time, this phenomenon in financial markets in 1995 has underscored the major problems increasingly faced by policy makers everywhere due to rapid technological development and the ongoing integration of financial markets across sectors and national borders. These include: liberalized capital controls result in rapid capital movements since monetary authorities have no control over their banks' activities abroad; these banks do take large positions beyond the amounts required to cover real transactions in goods and services, and in the process complicate management of the economy of the host country; the rise of international financial conglomerates whose complex activities are inadequately understood and not sufficiently regulated by domestic monetary authorities; the ease with which domestic financial institutions have used derivative transactions offshore as well as their cross-border networks, to undermine the intended impact of domestic macroeconomic policies; and the new uncertainty introduced by the profit motive of computerized financial traders on exchange rate indicators and their projections.

Whether uncertainty is caused by the derivative market or otherwise, it is a problem that arguably poses considerably greater difficulties for monetary authorities, especially in developing countries. In 1995, economies with substantial Yen-denominated external debt have found their outstanding debt burden suddenly soaring and debt interest repayments quickly rising above budgeted amounts despite maintaining conservative fiscal policies. Growth in export-dependent economies have slowed as exporters faced additional costs arising from volatile interest and exchange rates. Countries which have liberalized capital transactions have been literally "ambushed" by fund managers and financial market traders moving large amounts of capital in and out of these economies seeking to profit from the smallest window of arbitrage opportunity; all efficiently aided by their computer programs and international corporate network.

The Daiwa and Barings incidents have exposed the internal weaknesses of "established" financial conglomerates and the inadequacies of supervision, especially when this involves the grey area of international cooperation.

These recent developments, particularly the rise of international financial conglomerates, do indicate a need for further study on the implications for policy formulation. One area that would be of great interest is the impact of the cross-border transactions of international financial conglomerates on the capital account of the balance of payments. Similarly, the operations of transnational companies also impact capital market developments in that the greater resources available to them due to centralized operations in regional OHQs, enables them to also source profits through foreign exchange positions in addition to their traditional commercial activities.

The staff has drawn attention to the different developments between emerging markets in Asia and that in Latin America. However, there appears to be a general conclusion that developments in emerging markets are one dimensional and that any slowdown in equity markets or higher spreads for borrowing has been the result of the Mexican crisis. The impact of the Mexican crisis on the performance of other emerging capital markets could be over-rated.

First and foremost, emerging markets are no different from mature markets in being influenced by a complex array of economic, political and social factors. For instance, equity markets in Southeast Asia, Hong Kong and China are seasonally low in the first quarter of the year, due largely to profit-taking as the Chinese community cash in to celebrate the Lunar New Year. To implicitly assign such falls in stock market performances in the first quarter of 1995 solely to the Mexican crisis would be an over-simplification. It could also lead to wrong policy prescriptions.

Second, the statement that "investor interest has not rebounded to pre-crisis levels"could be misleading. There is no golden rule that new equity issuance by an economy must always be on an upward trend. It is perfectly normal that after a year or two of strong growth in new issues, investors would find a market over-saturated and become more selective in looking for quality issues. There are also other domestic factors that affect trading volumes and prices of emerging country papers. These include: fewer companies offering new issues, partly due to completion of major privatization exercises; fears by fund managers of adverse impact of over-heating in some economies; higher interest rates to curb inflation which would shift savings into bank deposits; the availability of alternative forms of financing; the instruments being offered, such as equity convertible bonds, spreads for which are determined not only by country ratings, but also the rating of the corporations; and the lower interest rate differentials amidst high liquidity in domestic banking systems which encourages companies to source domestic funds and avoid exchange risk costs.

The staff paper acknowledges that "the maintenance of sound banking systems . . . is an important element in the maintenance of sustainable macroeconomic policies". Reflective of this statement, some analysis of the banking problems in Latin America and other developing economies should be included in the paper.

The issue of resolving the problems of the Japanese financial system is no doubt important. However, it may be more important that the Fund also look at the problems and policy implications of this sector in a broader context. Banking problems are not confined to Japan alone. Recent Board discussions on Article IV consultations have highlighted banking and financial sector problems in a number of economies. It would be useful for future studies to see the different implications of banking problems as they impinged on developments in the capital markets.

Finally, I would appreciate further staff comments on the impact of the problems facing Japanese banks beyond those associated with the "Japan premium". In particular, has the poor performance of these banks impinged on borrowing sources for developing countries? If borrowing countries can easily source funds from other international banks, can one conclude that while the problems facing Japanese banks have implications on the disposition of U.S.Treasury bills, it has little impact in facilitating financing requirements of developing countries?

Mr. Kiekens and Mr. Jonáš submitted the following statement:

Let us begin with the emerging markets. At our last discussion of international capital markets in May, this chair saw many silver linings brightening the dark clouds that hung over the emerging markets after the Mexican crisis. Subsequent events have shown that this guarded optimism was justified, and today our assessment of the situation of the emerging markets remains by and large rather upbeat.

There are several reasons for our continued optimism. First, as the staff also notes, the emerging markets have weathered the spillover from the Mexican crisis faster and better than many observers expected when the crisis erupted. Second, the financial markets were frequently considered overactive and irrational right after the Mexican shakeup. The damage done by contagion effects extended even to countries with generally sound fundamentals. However, those countries that were damaged by the spillover effects of the crisis despite having sound fundamentals were among the countries whose financial markets recovered fastest and strongest. This shows that the international capital markets are behaving in a largely rational manner: they are paying attention to economic fundamentals and distinguishing between the good and no-so-good performers. As was observed during last week's discussion of country matters, market developments are now being driven mostly by specific country factors.

Finally, the Mexican episode has made investors more aware of the potential risks of investing in the emerging markets as a group. This greater awareness of investment risks should now be more realistically reflected in the price of securities issued by these countries, which should in turn reduce the danger that foreign capital inflows to these countries will exceed the levels justified by their investment opportunities and absorption capacities. During our May discussion, some speakers argued that flows to emerging markets like Mexico's had been based less on fundamental economic analysis and more on market sentiment. In recent months, the behavior of the international capital markets seems to indicate that sentiment has taken a back seat to thorough economic analysis. Many emerging markets have initiated far-reaching reforms, and the resulting investment opportunities should provide an important motive for sizable foreign investment flows even though the less rational motive of sentiment has disappeared.

In the major industrial countries, the foreign exchange markets were characterized in 1995 by high volatility whose causes have yet to be fully explained. The staff has identified many economic and political factors that could explain the large movements of the U.S.dollar vis-à-vis other major currencies.

Technical factors are considered to be additional culprits that exaggerated the dollar's movements. While we would certainly not deny that technical trading and derivative-related activities played a significant part, we would caution against viewing them as a fundamental cause of high volatility in foreign exchange and other financial markets.

We would argue instead that the increased volatility was primarily caused by shifts in economic conditions and expectations about the economic future of the major industrial countries, and that the technical trading was activated by, and was operating on, an existing volatility that originated from economic factors. After all, trading in derivatives and other instruments was not a new phenomenon this year. It was rather the emergence of a certain confluence of circumstances that enabled instruments like "knock-out" options to add to existing volatility.

An important political and economic factor feeding market jitters is the intensifying discussion on the prospects of the EMU. The staff reports that market participants attribute the steeper yield curve for the Deutsche mark compared with that for the U.S. dollar to the "EMU premium" for holding Deutsche mark-denominated instruments maturing on dates after the monetary union will probably be put in place. It is assumed that investors are worried that the common currency will be somewhat weaker than the deutsche mark. If this explanation of the behavior of yields on long-term German securities is correct, we would expect that yields of securities denominated in weaker currencies would also respond to the prospect of monetary union, although, of course, in the opposite direction: in other words, if long-term yields in Germany have a negative "EMU premium," we would expect long-term yields in countries with weaker currencies to show a positive "EMU premium." It may be objected that countries with weaker currencies will be unable to participate in the EMU, but in that case, there would be little reason for the existence of a negative "EMU premium" on the yields of German securities, since the prospect of a monetary union consisting only of strong currencies should not give the holders of deutsche mark-denominated securities much to worry about. In this connection, we also wonder whether it is not more likely that a positive "EMU premium" would be attached to the yields of assets denominated in currencies whose participation in the EMU is less likely. An alternative explanation of the steeper yield curve of the Deutsche mark over the U.S.dollar could be a market perception that, over the medium term, the dollar would appreciate vis-à-vis the deutsche mark. We would appreciate the staff's comments on these issues.

In Japan, although the authorities are finally acknowledging the seriousness of the banking system's problems, there remain some doubts in the markets that they are being addressed thoroughly enough. The magnitude of the problem, together with underlying conditions in the domestic economy, leave little hope that a quick solution can be achieved without the use of public money. The authorities should therefore no longer hesitate, but should quickly act to determine the extent of public intervention and define rules to guide the use of public money for assisting the banking sector. The recent agreement to use public funds to eliminate the non-performing assets of the "jusen" is a welcome decision that could help to stabilize the situation. There is, however, strong opposition to the use of public money to help stabilize the situation in the Japanese banking sector. An important condition for overcoming this opposition would be the visible willingness of the Japanese banks to cut their operating expenses and to make their shareholders bear part of the cost of cleaning up their portfolios.

And as the staff points out, the problems of the Japanese banking system are to some extent structural. If similar crises are to be avoided from now on, the underlying structural causes of the current problems must also be dealt with.

Mr. Clark made the following statement:

Although it was apparently written only for internal discussion, I would certainly endorse the publication of this document, which I found to be a valuable update to the August publication. Some of the issues covered in this document, notably market responses to trading techniques and banking sector restructuring, are sufficiently important to warrant public discussion. As I have noted previously, I am in favor of semi-annual publication of the International Capital Market studies as a vehicle to focus and improve the Fund's multilateral surveillance of global capital markets.

As indicated, I am essentially in accord with the staff's analysis and will focus my comments on three general areas: trading techniques and market response; derivatives; and banking sector restructuring.

The staff considers the effects of both coordinated intervention and options-based trading strategies on the movements in foreign currency markets in February and March of this year and concludes that they had some impact on the evolution of the dollar-yen exchange rate. While I agree that bunched, large-value transactions can have some temporary impact on the evolution of exchange rate movements, any persistent change in exchange rates still must be sustained by changes in fundamentals or in risk premia.

For example, the evidence regarding the effectiveness of coordinated exchange market intervention is hardly conclusive. Occasional Paper 116 on improving the international monetary system: constraints and possibilities, suggests that, by itself, such intervention has at best temporary effects. The intervention can trigger a sustainable change if it brings new information to the market that alters perceptions about economic and financial fundamentals or improves confidence in the policies of the authorities whose currency is under attack to reduce the risk premium. However, the U.S. dollar remained weak until the second half of the year, especially against the deutsche mark, which suggests that the coordinated intervention strategy was not as important as the report initially implies. Indeed, the staff indicates that policy actions by the Fed and renewed focus on favorable economic indicators ultimately accounted for a strengthening in the U.S. dollar exchange rate.

The report also suggests that a concentration of U.S. dollar 'knockout' put options written in the yen market contributed to an overshoot in the devaluation of the dollar against the yen. The proposition is that once the dollar began to weaken against the yen, the option writers had not only had an incentive to sell more dollars into the yen market to drive the exchange rate through the knockout price and, thereby, eliminate their option liability, but would also dynamically hedge their short option position by either selling dollars spot or buying U.S. dollar put options. The original holders of the knocked-out put options, stripped of their insurance, would also sell dollars to flatten out their exposed positions. In effect, the proposition is a version of the familiar concern that dynamic hedging can cause market overshoot. While there is ample evidence that this may be true in terms of trading-day effects, it is unlikely that these effects would persist in the value of the exchange rate. Indeed, technical persistence would seem to require an unlikely joint distribution of the option features characterized not only by a massed concentration around a narrow range of knockout prices, but also by a narrow maturity range on the European-style options--which would move back into the money as the dollar strengthens--and by a high share of trading volume. More generally, the fundamentals would determine the direction and persistence of the change in the exchange rate while technical conditions such as dynamic hedging in the currency option markets may affect the smoothness of that adjustment.

The staff has integrated the role of derivatives trading quite effectively into the analysis of overall financial market behavior. The discussion of knockout options in the foreign exchange market demonstrates how investors are able to lower the cost of foreign exchange hedging by purchasing only partial coverage at a lower cost than full coverage, betting that large exchange rate movements are unlikely over the option maturity. The discussion of tesobono swaps and of structured notes, as used by Mexican banks, is another interesting example of the financial engineering with derivatives, although one which is newer in name more than in substance.

For example, the structured notes as described in the report are similar to foreign currency swap deposits issued by commercial banks for the past 30 years. The bank buys a domestic currency deposit and books it as a foreign currency deposit at the current exchange rate and simultaneously writes a forward contract to buy-back the foreign exchange when the deposit matures. The bank is long a domestic currency asset funded by a foreign currency liability. Similarly, the tesobono swaps are simply cross-border repurchase agreements, which are often used by the foreign branches of U.S. investment banks to fund their foreign asset positions. In both cases, the bank has an uncovered foreign exchange liability.

In this event, the problem is not with derivative instruments per se, but with the management of the risk exposures that cross-currency transactions can create. As the staff has stated previously in another context, the Mexican banks lost money "the old-fashioned way" through bad asset-liability management.

I concur with the point made by the staff that derivatives do provide a vehicle for banks and fund managers to circumvent regulatory constraints on investments. They allow the manager to meet the letter of the law with regard to balance sheet positions while using derivatives to restructure the risk-return profile of that position. This obviously requires that the authorities demand improvements in financial reporting, risk assessment, supervision, and enforcement; but, it also indicates that investment opportunities now exist that have more efficiently manageable risks than in the past. While derivatives provide more ways to make money, they also create more ways to lose it and there is, therefore, a premium on good risk management.

The discussion of banking system problems in Latin America and in Japan and the approaches to resolution of those problems is a valuable section in the report and worthy of more emphasis. The section on bank systems in some of the industrial economies is equally interesting. The staff noted that, among others, banks in Canada have been able to restructure by acquiring a broad range on non-bank financial institutions. This financial conglomeration has allowed these institutions to exploit economies of scale and scope to produce improved profit margins and stronger capital positions, which is certainly the case in Canada. The staff also notes that global competition in corporate banking has narrowed loan margins sharply for banks and that regulatory authorities are concerned that there may be incentives for banks to adopt riskier portfolios in an attempt to widen out those spreads. However, narrower margins in corporate lending coupled with widening overall profit margins suggest that banking conglomerates are either cross-subsidizing corporate banking through wider margins and fees on other lines of business, which are more insulated from intense global competition, or simply gaining from scale and scope economies. Since many of the banking problems in Latin America and Japan have originated with, or exacerbated by, domestic portfolio problems, these operations should be examined more fully.

Finally, with regard to the banking problems in Japan, I concur largely with the staff's analysis, but would note that some recent actions by the authorities to resolve the problem provide reason for optimism. I agree particularly with the proposition that bank failures, leading to mergers, takeovers and even wind-ups, are a necessary response to overcapacity. Indeed, the authorities are actively encouraging this procedure. Also, even though improved disclosure requirements will be in force only by early next year, many of the stronger banking institutions are already publishing more complete information in an attempt to signal their creditworthiness. Progress in the negotiations regarding loss allocation for the home loan corporations has been reported and many of the larger banks are reporting earnings that are sufficiently strong to support loan loss write-offs.

Mr. Mesaki made the following statement:

As I generally agree with the thrust of the staff's analyses in sections I-III, I will limit my comments to section IV, on the financial system problems in Japan.

I found the staff paper commendable in clarifying the problems with the Japanese banking sector and in providing us with the most up-to-date information. However, I am not entirely comfortable with the staff's introduction and implicit endorsement of the view that my authorities are too optimistic about the pending financial system problems and have not been resolute in their efforts to solve them. I would emphasize that my authorities have fully recognized the problems and have worked around the clock to deal with them. Their specific agenda includes the early write-off of problem loans, the establishment of transparent disclosure procedures, and the smooth allocation of losses of failed financial institutions. Although my authorities are making their best effort to complete their agenda as quickly as possible, I would ask you to understand that this requires a comprehensive review of the existing system and is therefore time-consuming.

Specifically, my authorities are working very hard to formulate, by the end of this year, comprehensive measures aimed at coping with problem loans on the basis of the guidance of the Financial System Stabilization Committee. In addition, my authorities intend to submit bills to the regular session of the Diet, which will be convened in January, 1996.

The staff views my authorities' estimate of problem loans of ¥45.2 trillion as optimistic and refers to private analyses, some of which arrive at estimates of ¥60 trillion or more for the total amount of problem loans. I would like to emphasize, however, that my authorities' estimate is much more reliable because it is based upon first-hand, individual reports by depository institutions as of end-September, 1995 to the Ministry of Finance. Institutions that make false reports are penalized by law. On the other hand, it is unclear on what the private estimates are based, and they often include problem loans not held by depository institutions.

I concede that the staff is right in pointing out that loss-sharing among stake-holders has been decided on an ad hoc basis and that this has created uncertainty about the Japanese financial system. While I believe that there was almost no other choice but to take an ad hoc approach at the initial stage of the financial system reform, my authorities have decided to establish a more transparent framework on a loss-sharing rule, in particular with regard to the allocation of losses to financial institutions that have no stake in failed institutions. To this end, the Financial System Stabilization Committee is discussing a new scheme whereby resolution costs that are beyond the coverage of the Deposit Insurance Corporation will be covered by newly-introduced special levies charged on private financial institutions.

In addition, my authorities intend to submit to the upcoming regular session of the Diet bills aimed at introducing a more transparent rule for a limited duration on contributions from private financial institutions.

I share the staff's concern about the lack of disclosure by Japanese banks of information about problem loans. My authorities are determined to deal with this issue as quickly and aggressively as possible with a view to enhancing the self-discipline of financial institutions and to fostering a sense of responsibility on the part of depositors. As an initial step, it has been decided that the 21 leading banks will have to disclose all their problem loans beginning at the end of March 1996. In addition, my authorities have urged other depository institutions to disclose more information on problem loans. For instance, they have urged regional banks to disclose all their past due loans.

That said, my authorities believe that the above guidelines are a minimum and hope that many more institutions will expand the scope of disclosure voluntarily.

Actually, the 21 leading banks disclosed all the information on their restructured loans voluntarily, and ahead of schedule, in their interim settlement reports of end-September 1995. Moreover, many regional banks have voluntarily disclosed past due and/or restructured loans.

The Financial System Stabilization Committee is considering a new disclosure rule that would require banks to disclose all the problem loans as soon as feasible, within five years at the latest. It plans to announce its basic position by the end of this year.

In order to facilitate the resolution of failed banks, my authorities announced on November 22 that they intend to restructure the Tokyo Kyodo Bank and establish a brand-new "bridge bank" to which some of the assets and liabilities of failed banks would be transferred. This new "bridge bank" would be equivalent to the Resolution Trust Corporation in the United States.

Jusen problems are a symbolic issue with serious implications, and my authorities are giving immediate priority to addressing them is a timely manner. On December 1, 1995, a policy-making committee of the ruling three-party coalition instructed the Ministry of Finance and the Ministry of Agriculture to dispose of losses from bad loans resolutely and quickly, and to make use of various measures, including loans provided by the Bank of Japan and by governmental guarantees. The committee also instructed both ministries to prepare a plan to resolve this issue expeditiously on the basis of the above guidelines. In light of the high-level political commitment, my authorities are working on the Jusen problems with determination, with the goal of designing a specific strategy to solve them by the end of this year.

The staff paper mentions a "Japan premium" and emphasizes the seriousness of its adverse effects on Japanese banks. I fully agree that the systemic problems of Japanese banks underlying the "Japan premium" should be dealt with as a matter of urgency. However, I have some more comments.

First, I would point out that the "Japan premium", which widened after the Daiwa Bank incident in late September, has recently declined substantially. The spread on the three-month LIBOR is down from 58 basis points as of October 24, to less than 10 basis points as of December 8. In light of this, I feel that the staff paper might overemphasize the seriousness of this issue.

Second, while the staff says in footnote 1 on page 33 that the "Japan premium" reflects systemic issues, such as a general uncertainty about how aggressively the Ministry of Finance will close down relatively large banks, I believe that the "Japan premium" stems partly from distrust of individual Japanese banks whose credit ratings have been downgraded.

Third, I would emphasize that I have not heard that Japanese banks' foreign branches have ever had difficulty with financing.

Fourth, my authorities intend to carefully monitor the developments in this respect and will be prepared to take prompt and appropriate actions if necessary.

I note the staff's view that stronger and more active bank supervision is crucial. My authorities, having taken seriously into account the various criticisms triggered by the Daiwa incident, believe that they should embark on a fundamental review of the existing bank supervision system.

Specifically, they have established a new committee, consisting of concerned high-ranking officials of the Ministry of Finance, to discuss measures to: facilitate a smoother and closer exchange of information with foreign monetary authorities; strengthen the internal supervision of banks; formulate appropriate rules to deal with misconduct by financial institutions; and improve on-site inspections of Japanese banks' foreign branches and subsidiaries.

The committee intends to reach a conclusion as soon as possible on necessary actions to ensure the continued credibility of the authorities' banking administration.

While some Directors may wish to have the staff paper in question published, my authorities strongly object to publication, not only because it contains sensitive issues but because the chances are very good that substantial progress will be made on Japanese banking issues by the end of this year, especially in the legal area. If the staff paper is published as is, its contents will be noticeably out of date by the time of its actual publication. In addition, an increased workload will be required for its editing and publication.

I would urge the staff to incorporate updated information on the Japanese banking sector, together with the staff's comments, in the next staff paper on international capital markets, which will be published.

Ms. Lissakers made the following statement:

As usual, the staff paper for the current discussion is full of interesting facts and analyses. It makes clear the important point that international markets appear to have sorted themselves out in a fairly orderly fashion in the wake of the Mexican crisis and, indeed, in the wake of some overall exchange market volatility during the past year.

With regard to emerging markets, the spreads that had widened so dramatically in the immediate wake of the Mexican crisis have narrowed, although they have not yet returned to pre-crisis levels. Even with the wider spreads, the level of overall borrowing costs is now lower for emerging markets, at least in many cases, than in the pre-crisis period, because the overall level of interest rates has declined quite notably.

The composition of capital flows has also adjusted, with more credits taking the form of bank loans and private placements, and with fewer bond issues and less equity investment. A faint echo of this pattern is seen among the fast-growing Asian economies, but by and large the fallout there from the Mexican crisis appears to have been limited.

It is also important to note that Japanese institutions appear to be stepping up their yen lending to developing countries, even at narrower spreads than are obtainable on dollar-denominated credits.

It is interesting to note the increase in syndicated bank lending to emerging markets, because that represents a significant change in the pattern that has prevailed since the 1980s debt crisis. I wonder whether the staff could comment on why banks appear to have shifted their strategy somewhat from emphasizing off-balance-sheet activity to emphasizing on-balance-sheet activity. Does this reflect a stronger capital base? Does this reflect a declining rate of return on the off-balance-sheet activities? What exactly is going on?

The other phenomenon that dominates the international capital markets is the steady decline, since early 1995, of market interest rates, and in particular the very low level of interest rates in Japan. It would be useful if the staff could draw out somewhat more fully the implications of this trend. Is the decline in interest rates among the industrial countries linked? What is the impact of the decline in interest rates in Germany on the interest rates in the other industrial countries? Do these trends move autonomously or do they move together? If so, what is the conveyor belt?

I wonder whether the balance in both the Brady and equity markets in Latin America is to be interpreted as an increase in overall international liquidity, owing to a perceived improvement in policy performance and, therefore, their ability to attract investment, or whether it is simply the backwash of lower rates of return in the industrial countries. This is more than an academic question, because experience indicates that there may be a certain illusion among policymakers that they have a locked-in access to private capital, owing to their own policy performance, rather than seeing it as merely an indirect consequence of events that are primarily industrial country driven--i.e., developments in interest rates and rates of return on commercial loans and so on in the industrial markets.

I know an effort is under way to integrate the activities of the staff studying capital market developments with the day-to-day activities of staff working on country surveillance. I wonder what use is to be made of this analysis in terms of country surveillance.

As previous speakers have noted, there is a tendency in the staff paper to treat derivatives markets as separate from exchange, money, capital, and equity markets, rather than as an integral feature of these markets. I share some of the concerns that have been expressed about this. Indeed, there is a fairly negative treatment of derivatives overall. I certainly do not disagree that many derivatives are really nothing more than a one-way bet, rather than a prudential hedge, and perhaps more akin to a gambling contract than to an investment. However, it is also fair to say that derivatives have a legitimate function in financial markets that allows participants to hedge exposures and to take positions more easily. That, in turn, can enhance the liquidity and the efficiency of financial markets, sometimes reducing volatility as well as sometimes increasing volatility.

Even if derivative activity accelerates and amplifies short-run market movements, I do not think there is a strong consensus that such activity overrides the fundamentals on a sustained basis. The emphasis given by the staff to technical market dynamics may divert attention away from fundamental considerations. For example, exchange rate developments in the early part of this year were dominated primarily by the fundamental factors enumerated in the staff paper, and by technical factors, such as knockout options, while playing a role in very short-term interest rate movements and contributing to short-run turbulence as well as perceptions of greater risks. Nevertheless, as Mr. Clark noted, it would be implausible to suggest that technical factors, such as knock-out options, were a key determinant of the decline in the value of the dollar vis-à-vis the yen, from 100 yen to the dollar to 80 yen to the dollar over a matter of months. Technical developments do not really explain why some investors were not willing to bet heavily on the dollar's rebound.

The focus of the staff paper on how derivatives transactions might have weakened Mexican financial regulations is interesting. Certainly, financial regulations need to be designed and enforced with a full appreciation of how financial markets function, but not with a wish that life might be simpler or that market participants will forgo opportunities to profit from inconsistent macroeconomic policies. Financial engineering in the private markets will always strive--and at various points succeed--to outsmart and outmaneuver prudential regulation.

The fact that supervisory engineering can never really catch up raises an interesting question. There has been an effort to engineer supervision, to try to tailor it to the new risks and new financial instruments. This is really futile. It--particularly the use of these sophisticated financial instruments that can accelerate and enhance shocks to financial systems--raises some very interesting questions about banking regulation that are perhaps beyond our scope, but the near-universal capital adequacy standard devised by the supervisory group in Basle may in fact not be sufficient for banks in high-risk markets. By "high-risk markets," I mean financial systems where maturity structures are extremely short, which is typical in developing markets, and where there is an enormous vulnerability to exchange rate shocks that translate immediately into the cost of credit, and the creditworthiness--and ultimately the solvency--of financial institutions. What is needed is a much bigger pure equity capital cushion for financial institutions, instead of a lot of sophisticated risk-weighting formulas.

The Japanese banking problem has been one of the most unsettling developments of the past six months. The staff indicates that market concerns about the credit risk of large Japanese banks and the emergence of the so-called Japan premium are a consequence of past forbearance policy. This conclusion may be too general, given a good explanation of why the Japan premium emerged recently. In fact, it is not clear why the premium should have opened up in July, just when the authorities were moving away from forbearance toward actually closing insolvent institutions. The timing of the emergence of the premium suggests that something related to the failures of these domestic institutions that must have been at work. As the staff very clearly demonstrates, the Japanese authorities are dealing with each insolvency on a case-by-case basis, eliciting contributions from healthy financial institutions to support troubled ones.

Since each case is being handled on an ad hoc basis, there are no clear rules establishing liability for losses. This new uncertainty over the size of the contingent liability faced by large internationally active Japanese banks must account, at least in part, for a large component of the premium. We would expect the premium to persist until transparent burden-sharing rules are established. I note from Mr. Mesaki's statement that there is an intention to establish such transparent burden-sharing rules soon.

U.S. Federal Reserve analysts have noted that the Japan premium has a distinct year-end bulge, suggesting that at least a fraction of the premium is also attributable to seasonal factors. However, the premium does not decline sharply at longer maturities, so concerns about the credit risk of large Japanese banks must be present.

As we have indicated on previous occasions, faster resolution of the Japanese banking problem needs to be a top priority. Greater use of public funds is unavoidable. Still, the stress should be on the use of public funds to pay off depositors of failed institutions, not just on writing off nonperforming loans. Using funds to finance write-offs of nonperforming loans of solvent banks would increase moral hazards and government intervention in the economy.

I would also stress the need to restructure the banking system. Japan already has a small number of very large banks. Further concentration is not necessarily desirable. Allowing new entrants with clean balance sheets would do far more to improve the vitality of the Japanese banking system than would further consolidation.

It is striking to note how little change there has been in banking practices in Japan, despite the enormous backlog of bad debts. The staff notes that dividends continue to be paid at roughly the same rates as before, and there is little evidence of streamlining operations.

Garnering the necessary public support for the use of public funds to resolve the banking crisis might be a lot easier if there were more evidence that banks and their shareholders were bearing more of the costs of bad lending.

As I have indicated on previous occasions, greater priority should be given to liquidating the real estate collateral that now secures so many bad Japanese financial assets. Simply writing off the value of the assets on the banks' books is not enough. The property market will never function properly until the assets themselves are liquidated and revalued by the market, rather than on the basis of some notional appraised value.

As the staff paper notes, Japan is not the only country with serious banking problems. Weak banking systems pose one of the major hazards in the world of liberalized capital movements. The Fund needs to keep abreast of developments in this area, if it is to provide proper evaluations of international capital market developments. I realize the staff cannot cover everything in a single paper, but weaknesses in this area seem to crop up frequently in the work related to individual countries. Thus, there is a natural link between this research work and country surveillance work.

Mr. Mesaki and some other Directors have commented on the possible publication of this staff paper. The staff paper documents some significant new trends that should be shared with a wider audience, although redrafting would improve the overall balance of the paper. On a specific point, the Federal Reserve has called my attention to technical inaccuracies in the discussion of the Federal Reserve's cooperation with the Japanese monetary authorities in dealing with potential liquidity problems of Japanese banks operating in the United States. If the staff paper is to be published, corrections would be needed in this section of the paper, but I can take this up bilaterally with the staff.

Finally, there seems to be a subtext in the description of what has happened in the last six months in financial markets, which reiterates a well-established lesson in finance: the loss of confidence, or credibility, is extremely costly. We have seen a lot of examples of cases in which confidence has been lost over the past year, and this experience should serve as a reminder that the preservation of confidence and credibility should be a priority for every financial manager, public or private.

Mr. Esdar made the following statement:

At the outset, let me commend the staff for providing us as usual with a well written and concise document on the complex issue of international capital markets. Since I share most of the staff's findings, I would like to address only a few issues, where I have a slightly different view and make some points of emphasis.

The situation on international capital markets has been characterized by a number of uncertainties and events whose lasting effects have been difficult to predict. In this regard I would like to mention: the events in Mexico; the ongoing crisis of the Japanese financial system; discussions on how to deal with external imbalances between Japan and the United States; uncertainties about the cyclical developments in Japan and Europe; and changing sentiments on the possible reemergence of inflation and the related monetary responses in the United States.

Given this delicate mix of events and uncertainties, it is not surprising that markets did not always follow a very stable path. Capital and exchange rate markets had to react to more or less permanently changing environments which obviously was reflected in an increased trading volume and higher volatility.

Given this situation, I have certainly no problem to endorse the staff's view that financial markets on the whole have performed well.

The situation on the exchange markets also reflected these uncertainties. The most important contribution of member governments to stabilize the markets was to stabilize expectations by appropriate policy responses to imbalances.

Concerning the economic stimulation package in Japan, actually the avoidance of protectionist reactions to the trade imbalances between the United States and Japan and the credible intentions to consequently tackle the budget deficit in the United States have been more important for the stabilization of markets than foreign exchange interventions. The staff, in my view, places too much emphasis on the overall effects of such interventions. The amounts involved should also not be regarded as an indication of success. Interventions are only successful if they support appropriate policy reactions and do not "lean against the wind". Insofar, some of the exchange rate interventions have certainly been helpful especially because of their psychological effects. However, like Mr. Clark, I would caution against generalizing experiences which reflect a particular situation.

Closely related to this question is the issue whether certain kinds of derivative instruments have contributed to increased market volatility. There is no easy answer to this question. Different instruments have different effects. For example, the increase of volatility ascribed to so-called knock-out bonds may have been mitigated by supplementary or complimentary hatching or matching instruments. In general, I am somewhat concerned that when discussing the effects of those instruments we tend to loose sight of the main causes for fluctuations of markets, that is, insufficient predictability of policies, caused by short-termism and inappropriate policy responses to macroeconomic and structural imbalances and even more general, the uncertainties connected to the future, which financial markets try to capture.

Let me now turn to the banking situation in Japan. I think this issue has been discussed frequently in the past, therefore I can be very brief. I can fully go along with the staff's analysis as well as the suggested policy response. It is certainly true that there is a need to establish and to implement a coherent policy to deal with loan losses which is credible and foreseeable for the markets. It may include the provision of public money to recapitalize weak but structurally sound banks. Mr. Mesaki in his statement has informed us that important steps into this direction have already been taken. I am looking forward to the staff's assessment.

The losses of the Daiwa Bank are certainly a separate and not related issue. But they reflect to some degree the concerns about insufficient transparency of banking supervision in Japan.

With regard to emerging markets, the events in Mexico have enforced and even widened differences in conditions and access to financial markets between most Asian and several Latin American countries. Such differences in spreads and maturity structure increasingly reflect differences in macroeconomic and structural performance and in the overall openness of markets in the countries concerned. Insofar, markets increasingly perform as surveillance agencies, rewarding prudent policies while at the same time levying risk premia for countries who fail. This has been evidenced again by the reaction of the markets in the aftermath of the Mexico events.

Finally, some brief remarks on the German yield curve. In our view, there is no convincing evidence that the German yield curve--which is in fact steeper than that of the United States--is influenced especially by an EMU premium. First, there are lots of different factors which influence the yield curve in the United States and in Germany. For example weaker cyclical expectations for Germany may have had its effects on the German interest rate structure. The budgetary discussions in the United States may have dampened inflationary expectations and insofar long-term interest rates in the US. Differences in the interest rate structure may also reflect exchange rate expectations.

Second, more concrete on the so-called EMU premium: we have no convincing empirical evidence that such a premium exists. On the one hand, a differentiated analysis of interest rate structures comes to the conclusion that interest rates on maturities of 5 to 7 years--the likely EMU take-off period--have not increased, but that increases can only be observed in the longer maturities of 10 to 12 years.

It should also be noted, that Swiss interest rates show a similarly steep yield curve as in Germany and Mr. Kaeser can certainly confirm that for the time being his country does not intent to join the EMU. This is especially important in view of the widely exaggerated reports of capital flows from the Deutsche mark to the Swiss franc because of EMU related factors. If these flows were really so important, we should expect the Swiss yield curve to flatten, something which has not taken place up to date.

To conclude, let me again emphasize that notwithstanding these comments we very much appreciated the paper which again reflects the high standard of the Fund's capital market papers.

Mr. Berrizbeitia made the following statement:

I find the Interim Report on International Capital Markets an informative, interesting and well written paper that updates quite satisfactorily the May report on the same issues.

As regards the issues for discussion, my opinion is that major financial markets have performed well on the whole; that Japan's financial problems are being handled in an increasingly effective manner by the authorities, as has been made clear by Mr. Mesaki, although further efforts are probably necessary as suggested by the report; and that differences in access to Capital Markets by developing countries generally reflect differences in fundamentals. But rather than commenting in detail on these issues, which are dealt with quite satisfactorily in the report and in the several useful statements by other Directors, I will concentrate my remarks on the related issues of transparency and timeliness of information to these markets.

The priority and importance which the Fund has assigned to the issue of transparency and timeliness in the supply of information to markets, is well justified by the evidence contained in the Interim Report on International Capital Markets which is the subject of today's discussion. Indeed, the issues of transparency and information are a common theme, or better yet, a common lesson, that cuts across the three main headings in this report: the major international markets, emerging capital markets and the financial system in Japan.

While others more familiar than I with the practical functioning of derivative markets can have differences of opinion as to the effects which derivatives may, or may not have had on the increased turbulence of foreign exchange markets during 1995, what is clear from the staff document is that there is not enough transparent and timely information available to the supervisors and regulators of such markets, which limits their ability to effectively exercise their functions in the context of the globalized capital markets.

The limitations to regulators and supervisors are reflected not only in the apparently excessive volatility of the principal exchange markets earlier this year, but also in the circumvention of prudential regulations on foreign exchange positions, by Mexican banks, through the use of diverse financial instruments available through capital markets. They are also reflected in the concerns expressed by domestic bank regulators that fierce competition for customers in an increasingly global marketplace could lead to banks "repeating the problems of the past"; that is reducing lending standards, taking excessive risks and over-extending balance sheets. In fact, given the relatively unregulated nature of many international financial market activities, it is rather surprising that episodes such as the Barings and Daiwa "incidents" have not occurred more frequently in the recent past.

Although the relatively scarcity of such "incidents" hopefully reflects a healthy dose of self-regulation and self-supervision by financial institutions, one wonders if we have so far only seen the tip of the iceberg. In this context, it is significant that the "Windsor Declaration" and the document prepared by the Global Task Force on Financial Integrity both recommend greater disclosure, more information, and more extensive communication and reporting: in other words, more transparency and timeliness in the availability of information on these markets.

The issue then is how to increase international cooperation to promote more effective supervision or regulation of global capital markets; in this respect, both of the initiatives mentioned in the staff report are welcome and deserve support. While the Fund is already playing an important role regarding the publication of economic data by members, I wonder if there is a further role for the Fund to play in promoting increased transparency of such markets themselves.

The section of the report on Emerging Capital Markets brings the same message home. We, of course, do not need being reminded that the role of capital markets in the Mexican crisis, lies at the origin of our recent initiatives on data publication and transparency and the priority which we are attaching to these efforts. So there is no need to repeat the same message again.

However, just for emphasis, the evidence in the report does indicate that, after the initial herd instinct reaction, capital markets discriminated fairly quickly across regions and across countries within regions, and that countries with strong fundamentals recovered fastest and strongest, to use Mr. Kiekens's and Mr. Jonáš's words. The moral of the story is that--the next time around--markets will be able to differentiate more quickly and more efficiently, the better the information made available to them on any given economy; so countries should hasten to join the bandwagon.

The Japanese banking situation also brings out a similar message. It seems that, in addition to the bursting of the real estate bubble, the "lack of transparency and lack of disclosure" have had more than a little to do with the Japanese banking problems. Mr. Mesaki reinforces this point when he indicates that one of the main priorities of the Japanese authorities regarding the banking system is the "establishment of transparent disclosure procedures", and that the review of the banking supervision system will include measures "to facilitate a smoother and closer exchange of information with foreign monetary authorities." Japanese banks seem to have caught on to the idea as well, since many of them are publishing more complete information ahead of schedule, to signal their creditworthiness we are told by Mr. Clark.

The Interim Report on International Capital Markets has provided the opportunity to comment on three different types of markets, all of which are interrelated and integrated into the Global Capital Marketplace, and all of which can benefit from improved information and transparency. New opportunities and new perils will continue to arise as these markets evolve over time; but this is one lesson that is common to all markets and which will need to be continuously emphasized. The Fund's own activities in this regard are on the mark and well under way, but perhaps it is time for the Fund to emphasize this message to a broader international audience.

Mr. Al-Tuwaijri made the following statement:

I join previous speakers in complementing the staff for producing this informative and interesting update of developments in the International Capital Markets.

Turning to the issues raised in the paper, I will only make a few, brief comments as the Board has touched on most to these issues during the past six months in the WEMD and World Economic Outlook discussions.

It is not evident that there has been an increase in volatility in major international financial markets. Chart 2, for example, does not seem to show increased volatility in 1995 vis-a-vis the previous three years. Having said this, I can agree with the staff that the financial markets have on the whole performed well despite large shocks to the system. Indeed, the increasingly wide range of hedging and trading instruments as well as increased opening of capital markets may have contributed to the resiliency of these markets. It is important to continue to reap the benefits of trading these instruments while minimizing the risks of such trading. In this regard, I welcome the increased emphasis on enhancing cooperation among regulators.

While I agree that technical factors and derivative-related activities may have played a role in the sharp depreciation of the dollar vis-a-vis the yen during February-April, it is not clear that it was a very important contributor. The reinforcing nature of many factors, that are detailed in the staff paper, may have reduced confidence and led to overshooting. Moreover, there was the perception in the financial markets during that period that concerns over the sharp depreciation of the dollar were not equally shared by all the G-3 authorities. A reversal of this perception during the second half of the year, buttressed by the coordinated intervention, may explain the subsequent rapid appreciation of the dollar.

The emergence of the "Japan premium" is likely to undermine the competitiveness of Japanese banks in international lending, especially given the substantial narrowing of spreads over LIBOR to borrowers in OECD countries. Thus, it is important to implement a comprehensive policy for addressing the banking difficulties in Japan which are the root cause of this problem. In particular, strengthened supervision and disclosure requirements are called for. Moreover, it is important to have a clear picture of the magnitude of the problem debts, as well as the burden sharing rules for losses stemming from these debts. In my view, it is essential that the banks absorb the bulk of such losses. In this regard, I share the staff's view that banks can provision at a faster pace by reducing their dividend payments and cutting administrative costs.

Fourth, one of the lessons that we learned from the Mexican crisis is that beyond the initial shock financial markets are quite discriminating. As the paper rightly points out, the impact of the crisis on Asian countries has been less pronounced than on Latin American countries. Even in the latter category, the impact was lowest on Chile. Thus, on the face of it, it will appear that the difference in yield spreads are due mainly to perceived differences in fundamentals. It should be noted, however, that the risk premiums for the differences in fundamentals may have increased following the Mexican crisis.

Mr. Cippa made the following statement:

Let me start by welcoming this interim update and expressing my appreciation to the staff for the excellent analysis it has provided for today's discussion, which highlights recent developments and the performance of the international capital markets. I broadly agree with this description and will limit my comments to the questions that are proposed for discussion.

We agree with the staff that the reduction in short-term interest rates in many countries has launched a rally in financial markets and will probably allow them to end 1995 with a good performance. We do not quite understand, however, why the staff opposes good performance to the increase in trading volumes and volatility. However, I agree that nowadays, because of the various structural reforms introduced over the past few years, financial markets are in general more robust to cope with sudden changes in both volatility and trading volumes.

As regards the second question; in principle, we are confident that derivative markets are an important instrument for investors to improve their hedging strategies and, therefore, implicitly increase the liquidity of the underlying assets. This, in turn, should reduce volatility in the respective markets. In the specific case of the dollar/yen exchange rate, the existence of knock-out options may have increased volatility during February-April 1995. The mechanism that would have triggered the alleged overshooting does not seem, however, to be specific to this type of option or to options in general, but rather refers to the more general problem of market participants covering their short-term positions. In this respect, the key question is to know whether there has been a bunching of such options around a specific price.

Studies have argued that such a mechanism could have been responsible for forcing the lira out of the EMS in September 1992. In this case, the exchange rate bands would have provided a natural level at which to write the contracts. However, for the dollar/yen exchange rate, we do not see why a specific rate should have attracted more attention than others. However, given the fact that most market participants use the same global information and analysis systems, identical critical values could have been decisive for many actors. If this were actually the case, the effects of such global information systems on volatility should be further investigated.

We believe that speculative activities, and the need for investors to hedge future levels of exchange rates, will be reduced only by lowering market uncertainty and stabilizing expectations. This can be done through the pursuit of sound and transparent economic policies and the full disclosure of the relevant information to all market participants.

On interventions, we share the views of Mr. Esdar.

The limited disclosure requirements for Japanese banks have not dispelled fears that the nonperforming loan problem facing Japan could, in fact, be even bigger than officially estimated and that the big international Japanese institutions could be affected. The collapse of several financial institutions this summer triggered fears of a contagion and foreign banks started to ask for a premium on their lending to Japanese banks. Although only some institutions may be facing this problem, the whole sector is being penalized. The news that Daiwa had lost US$1.1 billion in bond trading in New York intensified this concern. The estimation of bad loans by the Ministry of Finance and the publication of the interim report by the Financial System Stabilization Committee are in this respect welcome, although they may be seen as overdue and overoptimistic. The figures mentioned are considerably below the estimates published by the private sector, which are on the order Yen 60-80 trillion. In this respect, I take note of the reassuring information provided by Mr. Mesaki in his helpful statement.

The next step would be to produce data for individual banks. This assessment, however welcome and necessary, is in our view not sufficient. Japan's problems in the financial sector are also of a structural nature. The bad loan problem, in general, has raised questions on the ability of Japanese banks to assess credits adequately. The recent disclosure of losses at Daiwa revealed that internal management controls were inadequate and that bank supervision may have been lax and secretive. We strongly support the view, therefore, that a more active stance be adopted in the resolution of the nonperforming loan problem and of the structural deficiencies that this crisis has revealed. The credibility of the powerful Ministry of Finance is at stake! By the way, we should remember that Japan, for obvious fiscal reasons, has been by far the most restrictive industrial country in the limitation of the precautionary reserves that banks were allowed to constitute before taxes.

On the last question, although the post-crisis recovery of many emerging markets has been impressive, access to international financial markets is still a problem as demonstrated by higher interest-rate spreads, shorter maturities, and fewer corporate issues. This problem seems to be more acute for several Latin American countries. We agree that at least part of this problem stems from differences in fundamentals. The key problem facing several Latin American countries is the one of credibility. Their authorities have to implement restrictive macroeconomic policies in order to protect their exchange rate policy. However, the high social costs implied by this restrictive stance induce many market participants to consider this strategy as unsustainable and to believe that it will be sooner or later abandoned. For most Asian countries by contrast, there does not appear to be such a dilemma. The problem is overheating and the main challenge is to achieve a soft landing.

Finally, I wish to ask staff, like Ms. Lissakers, how the activity of the capital markets program can be integrated into the surveillance exercise.

Mr. Autheman made the following statement:

Like previous speakers, I find this interim update very interesting. I appreciate the candor of the language, and I share Mr. Mesaki's view that this sort of interim update should not be published so that we retain the possibility of discussing a very candid and sometimes innovative report.

Question 1 does not seem very candid to me. We all know that every time we are asked to respond whether markets on the whole performed well, we always answer yes. The point is that we should rather focus on misalignments which have occurred throughout time. When you look at the last two years, we have been through interesting misalignments--the bond market misalignment two years ago, the emerging market misalignment one year ago when everyone, including Swiss banks, as Mr. Kaeser told us, were upbeat about Mexican prospects, and the yen misalignment early this year. I think that our task is to keep track of potential misalignments and analyze how and why markets have diverged from fundamentals, knowing that on the whole they perform very well and are very resilient.

I cannot address the second question. I could tell you what the views of my central bank's experts are about knock-out options. They are rather close to Mr. Clark's, but I am not good enough of an expert to intervene in this debate. It seems to me that this may be part of what happened, but only a part. I would like to elaborate on two interesting points which have been identified in the report. The first one relates to emerging markets.

First, I think that it is good to see that markets are discriminating better among countries. And since Asian countries' fundamentals are generally better than Latin American countries' fundamentals, it is good to see that Asian markets have reacted better than Latin American markets.

What puzzled me was the discussion on the role of derivatives in the Mexican crisis. There is a general sense of unease among central bankers and finance ministers whether we have a proper regulation of derivative markets. We all know, as experts, that derivatives are very useful and fundamental instruments for hedging risk, but we are not confident that the regulation standards are what they should be.

Without being able to elaborate very much about the somewhat elliptic development of the staff on the role of derivative markets in what we could call the background of the Mexican crisis, it seems to me that they have touched here on an interesting issue. We must continue to work and improve our understanding of the nature of risk that the very rapid development of derivative markets--much more rapid than the capacity of central banks to understand every development--makes for the stability of the international financial system.

Finally, I welcome the exchange of views between Mr. Ito and Mr. Mesaki on the Japanese banks' situation and prospects. We see the change going on in Japan as far as the recognition of the problem is concerned, and we see the steps taken by the Japanese authorities. Obviously, Japan is addressing the difficulty by imposing on itself very tight constraints, the constraint that banks should not be allowed to fail and the constraint that fiscal resources should not be allowed to be used; and, therefore, the major action taken is to provide liquidity at almost 0 interest rate, which implies a very sharp resumption of monetary growth; and indeed monetary growth is now increasing very rapidly in Japan. We have some concern about the proper balance of fiscal and monetary instruments used to handle the crisis.

A second cause for concern is identified by Mr. Mesaki himself, in his statement. When he tells us that the authorities are the ones who are best able to estimate the losses. I agree with him. But, meanwhile, he indicates that he shares the staff's concern about the lack of disclosure by Japanese banks about problem loans. I read it as an interesting answer of Mr. Mesaki to the views of the staff. Clearly, major progress in disclosure is needed to restore confidence that this crisis is kept under control and is evolving well.

Mr. Kang made the following statement:

Sizable movement of portfolio capital to and from emerging markets appears likely to continue in 1996 and beyond. Moreover, there seems to be considerable scope for institutional investors in industrial countries to further diversify their portfolios by investing in emerging markets. One indicator of this is that there remains a significant difference between the emerging markets share of global market capitalization and the emerging market share in the portfolios of most institutional investors from industrial countries.

Volatile capital flows are an important problem facing emerging markets and are likely to play an increasingly influential role in the future. Developments in this area will need to be watched closely by the Fund. To add value, the Fund must ensure it is in a position to provide practical and applicable policy advice, tailor-made for the circumstances faced by individual member countries. Moreover, Fund staff need to be specific in their policy recommendations; they need to go beyond making general recommendations on the need for exchange rate and fiscal adjustment.

As regards recent developments in emerging markets, the staff point out that surveys of institutional investors in industrial countries suggest the overall share of foreign investment allocated to emerging markets has remained stable in 1995. At the same time, investors seem to be discriminating more between regions, especially between emerging markets in Asia and Latin America. Indeed, it is becoming increasingly apparent that adjustment of international portfolios took place after the Mexican crisis. It seems that portfolio weights given to Asia have increased at the expense of portfolio weights given to Latin America. This raises a number of interesting issues.

First question: it is worth asking whether the World Economic Outlook projection of a significant fall in net capital inflows to Asia remains appropriate, given that a starkly different picture is being presented by private forecasters working closely with those who are actually doing the investing. I understand the aggregate World Economic Outlook projections are based on a bottom-up approach which reflect forecasts made by each country desk economist. This approach has its merits, but the results need to be reconciled with the views and expectations of the relevant market players, particularly when differences in outlook are large enough to have policy implications.

Second question: there is an issue whether institutional investors' preference for Asian emerging markets over Latin American emerging markets is justified on the basis of fundamentals. What the so-called fundamentals might be in this context is difficult to pin down. A range of factors could feed into an investor's assessment of risk and return in emerging markets including things like credit risk; market liquidity; political risk; and portfolio considerations, as reflected in the relationship between past and expected future movements in exchange rates, interest rates and equity prices. You would also expect investors to discriminate on the basis of underlying macroeconomic criteria as depicted by the data. Aggregates that could be influential might include the size and sustainability of the current account deficit; a country's saving rate and public sector deficit; the inflation rate; the strength of banks' loan portfolios; and the size of external debt. I would suggest that the supply of capital would to some extent reflect the demand for it. All in all, a brief look at the macroeconomic data does seem to justify the regional distinction now being made by capital markets.

For the most part I believe the fundamentals as I have described them play a central role in the determining the allocation of global portfolio capital. Nevertheless, sometimes it is difficult to explain the underlying rationale for capital movements and in this context I would note that some Asian countries have been experiencing intermittent periods of disturbance in exchange markets caused partly by tensions arising in Latin American capital markets. There is a strong need for the Fund to continue to keep a close eye on developments in that regard; also to be in position to offer practical and specific policy advice when called upon, taking into full consideration policy implications to the real sector.

Regarding publication of this paper, I concur with Mr. Mesaki's position.

Mr. Leiva made the following statement:

Let me start by commending the staff on the interesting and informative paper before us today. The May papers were especially rich in topics and issues for analysis. This time, we have a well focused report which allows us to follow the impact of the early 1995 turbulence in emerging markets, revisit policy challenges of a regulatory nature and review the latest developments in the major capital markets. I will make a few remarks on the first two points.

Emerging markets have recovered from the Mexican crisis beyond the expectations of our May discussion and the prospects for continuing capital flows to these markets are solid. Asian markets, in particular, experienced a quick rebound to pre-crisis levels.

Even in the Latin American markets, recovery is better than expected. I would like to highlight the significant contribution to the reversal of the first quarter situation made by the Mexican, Argentinean and Brazilian policy responses, predicated in the cases of Mexico and Argentina on strong export growth.

Following Mr. Jonáš's and Mr. Kiekens's lead in psychological analogy, I would say that investors' sentiment--our patient in this case--has quickly overcome the first paranoic reaction to the Mexican crisis shock treatment.

As to the schizophrenic attitude with respect to rational expectations derived from economic fundamentals, there has been an improvement in the patient's behavior during the last few months. In practice, investors have been discriminating not only between regions but also among individual emerging markets.

The "Issues for Discussion" section of the paper asks for views on the differences in accessing international capital markets between most of the Asian and several Latin American countries. The basic question is: are the markets working properly and have investors learned their lesson?

The answer can not be a general one for all cases. Some movements could be linked to political perceptions or misperceptions rather than to sound economical analysis. This is the case, for example, of the November instability of the Mexican peso exchange rate. More generally, after the first quarter of this year, the behavior of the markets has shown a closer relationship to policies and performances of the respective countries.

Last May's papers stressed the importance of financial supervisory and regulatory issues. Today's paper analysis on the influence of derivative use in exchange rate movements--partial as it might be--adds urgency to the implementation of the initiatives to adapt supervision and regulation to the new dynamic processes observed in financial markets. The explanation of the problems of the Japanese banking sector and the efforts to strengthen the Mexican banking system show that regulatory challenges are multiple.

This chair maintained, during the last May discussion, that the Fund has an important role to fulfill in fostering international cooperation in this area, particularly in sharing information with member's supervisory and regulatory agencies. I think the discussion on "Macroeconomic Implications of Banking Supervision", scheduled for the first half of next March, should provide an opportunity to exchange ideas on the Fund contribution on this matter.

Mr. Wei, speaking on behalf of Mr. Zhang, made the following statement:

At the outset, I would like to thank the staff for their comprehensive and well-focused report on the development of international capital markets. On the issue of Fund surveillance activity with respect to the international capital markets, I associate with others that the focus of exercising the surveillance should not shift away from industrial countries. In retrospect, I can still recall that in the discussion of this issue last May it was pointed out by some Directors that the capital markets in industrial countries had been neglected in the staff report. On this occasion, I am pleased to note that this update is more balanced in the sense that industrial country issues were increased and paid more attention. In this spirit, I will focus my statement on the performance of both industrial countries' markets and the emerging market.

On the capital market development in industrial countries, the 1995 international market has been characterized by the substantial exchange rate misalignment among major currencies, with a sharp depreciation of the U.S. dollar vis-à-vis the Japanese yen in mid-April, followed by a dollar rebound in mid-September, as a leading phenomenon. Such a development is by no means less pronounced than the post-Mexican crisis effect on emerging markets. I am pleased to see that the staff has made great efforts in covering this important issue in Part I and Part III of the report. We certainly agree with some Directors that the market performance over the recent months has been characterized by a lot of volatility. Given the massive deviation of the major exchange rates from their economic fundamentals, I cannot be too optimistic about the market performance in the foreseeable future, especially concerning its adverse impact on some of the developing countries, where the yen-denominated debt increased sharply and on a number of countries where their less developed fiancial markets have constrained their ability to hedge exchange rate risks.

After reading the report, it seems to me that an explanation for the volatility in the capital market is more technical than fundamental. Of course, as the market grows more complex than ever before, we appreciate the staff analysis of market behavior on more technical grounds. However, given the difficulty in assess whether derivatives can help iron out the volatility or, adversely, intensify it in the real market practice, we believe that market sentiment is basically guided by the participants' evaluation of economic fundamentals of the related countries. In this connection, we would appreciate it if the fundamental reasons underlying market behavior could be analyzed more thoroughly. I appreciate these are very complicated issues for the staff to respond to immediately. However, the staff is encouraged to bear these issues in mind in their future work.

On the intervention issue, I agree with the staff that the coordinated exchange market intervention have played an important role in correcting the temporary misalignment of the major currencies. However, the difference in the extent of intervention by major countries may reflect their different attitudes toward intervention. As to whether intervention can work in the face of overwhelmingly large market forces, we are of the view that intervention at the right time, when the direction of is in line with economic fundamentals, will be beneficial. In light of this, the industrial countries should not abandon their attempts to coordinate market intervention. Rather, they should strengthen their efforts in this regard.

The staff is correct in distinguishing the differences between the impact of the Mexican crisis on Latin American countries and on Asian countries, and I think there is still room to draw the line more clearly. For example, on some occasions, the assessment of the Asian market is mixed with that of the European market and the Middle Eastern market, and the differences in the Asian market performance, as compared with the Latin American market, is not fully reflected.

In our view, the fundamental reasons underlying the differences lie in the differences in the capital inflow structure, economic performance and the way of utilizing the capital inflows. For example, the portfolio investments in Asian countries are less significant than in Latin American markets. The importance of containing the contagion effect from spreading to other markets cannot be overemphasized. In this connection, it would help the market participants, especially those non-residents, to sense the market in a more realistic way if the Fund would be more timely in sending information with objective assessments of different market characteristics. Such an approach will help reduce the overreaction of the market and avoid unnecessary costs both for the Asian market and the international market as a whole. Therefore, to draw this lesson from the post-Mexican crisis situation will enable the Fund to be more effective in helping member countries to be less affected in a crisis.

On the issue of the Japanese banking sector, the Japanese authorities should be encouraged to further enhance the transparency of the banking system and strengthen the regulatory framework. I think this lesson should also be well taken by other countries in order to quicken their pace in building sound regulatory systems in their banking sectors. In this regard, we are pleased to note from Mr. Mesaki's very helpful statement that the authorities have taken a number of measures to deal with the issues of the banking sector. I understand that the full implementation of the above-mentioned measures will need time to take effect. However, if necessary, further measures must also be considered.

Mr. Kyriacou made the following statement:

The interesting and informative update of the developments and prospects in the international capital markets is welcome. It should be expected that the next step for the Fund will be to translate this useful analysis into clear lessons for policy makers, which can be incorporated in program design and surveillance. In this light, it seems that the main challenges for policy makers lie in improving banking supervision, most notably in emerging markets.

Regarding the issues for discussion, let me first make four remarks on developments in the major financial markets. I will then turn to emerging markets and finally, I will make a few comments on the problems with the Japanese financial system.

First, on major financial markets, it should be noted that last August's coordinated intervention was preceded by deregulation measures in Japan which increased the scope for Japanese institutional investors to invest abroad. These measures made markets more upbeat about prospects for dollar recovery. Thus, the interventions gave market sentiments a further push in that direction. This is in contrast to earlier interventions that were "leaning against the wind." The effectiveness of interventions with, instead of against, the market could be an important strategic lesson for central banks.

Turning to my second remark, the staff notes that the increase in the spread between eurodollar and T-bill rates could have been due to banks becoming more lenient, for instance by venturing into higher-risk lending. To what extent, however, could this increase in the spread be attributed to increased demand for T-bills, among other things due to large purchases by the Bank of Japan? This factor's role is suggested by the recent decline in the spread that went along with a decreasing demand for T-bills, pushing the yield upwards again.

My third remark on the major financial markets relates to volatility, which it is generally accepted that exceeded the levels warranted by fundamentals. Albeit hard to measure, the effect of technical factors on short-term market volatility cannot be denied. Nevertheless, even though the proliferation of market instruments need to be watched, as in some cases they can add to volatility, they should not be considered as a cause of serious concern in the long term. Since this proliferation of market instruments is associated with financial innovations, it should be expected that along with the benefits, it would inevitably introduce some new challenges, which can be addressed by improvements in the financial infrastructure and strengthened supervision, as well as by the spreading of knowledge about these instruments and our better understanding.

As a fourth and final remark on major financial markets I have a small question on the banking system performance. The staff paper speaks of performance in major industrialized countries, noting lackluster developments in continental Europe, with the exception perhaps of Germany. Does the staff think that such lackluster performance applies to all Continental Europe or do they refer to only major industrial countries in Europe? I had understood, for example, that in some of the medium-sized countries, such as the Netherlands, the banking sector exhibits vitality as reflected in the recent purchase of Barings by ING bank.

Let me now turn to the emerging markets. The staff notes that not all emerging markets have regained access to international capital markets at the same conditions which prevailed before the Mexican crisis. Apparently, the markets are discriminating more between different countries on the basis of economic fundamentals. Surely, this refinement of market discipline can be welcomed by the Fund. To complement this, debtors should be stimulated to listen to these market signals. For instance, countries which can only sell short-term securities guaranteed by the government should act with restraint in their external financing policies, as the market is obviously telling them that their creditworthiness still leaves much to be desired for.

This remark leads me to the second and last comment on emerging markets, which relates to rebuilding credibility. For any policy efforts aiming at strengthening economic fundamentals to be successful, they must also be perceived as credible by the markets. Therefore, countries with a history of prudent and consistent policies have an advantage over countries with a poor track record. It is inevitable that the latter countries might experience a longer lag or greater difficulties in reaping the benefits of implementing prudent policies, as credibility cannot be built over night. In other words, these countries have to keep paying a "premium for past mistakes" until markets become reassured. One important way for these countries to speed up the process of reassuring the markets is, of course, through greater openness and transparency.

As to the problems of the Japanese financial system, the concerns expressed by the staff about the potential systemic implications and further negative effects on the macroeconomy are shared by this chair. At the same time, it should be noted that banks' net operating profits in the first half of the current financial year have strongly improved. Although some banks still face serious difficulties, other banks might be able to overcome their own problems in due course.

In light of the existence of the so-called Japan premium, a decisive but well-balanced approach toward the financial system's problems is needed. Most importantly, the Japanese authorities should set forth as clearly and as quickly as possible their policy to resolve the crisis, which could require the use of public funds and cooperation between individual banks. The use of public funds should be as limited as possible, to avoid distortions in the market. Likewise, greater transparency through more detailed disclosure is needed to reduce uneasiness in international financial markets in the short run and to improve market discipline in the longer run. Finally, could the staff comment on the distinction between the supervisory implications of the Daiwa affair, where losses were a consequence of fraudulent behavior, and the banking crisis?

Mr. Andersen made the following statement:

I would like to join others in welcoming this interim update to the August publication on the International Capital Markets and to commend the staff for a very interesting and well-focused paper. I believe that such semi-annual updates are very useful in our surveillance endeavors and would be in favor of continuing this practice in the future.

I broadly agree with the staff's analysis and conclusions, and will limit my comments to a few remarks on the four issues that are proposed for discussion.

First, to a large extent, I concur with the view that despite the increase in trading volumes and volatility during parts of 1995, international capital markets have on the whole performed well. However, it should not be ruled out that the volatility in exchange rates and interest rates may have had a negative impact in some countries, including countries where the share of small- and medium-sized firms that are active in international trade is relatively high, since they may find it relatively more difficult and costly to hedge against the risks. Regarding the role of coordinated exchange rate intervention, I fully share the views mentioned by Mr. Clark and Mr. Esdar and supported by Mr. Kaeser, but would like to add that the timing and strategy of more recent attempts, i.e., leaning with the wind in relatively thin markets, seem to have surprised the markets, but may not continue to do so. Accordingly, I find that the report goes too far on page 2 where it is said that "coordinated exchange market intervention seems to have played an important role in correcting the temporary misalignment of the major currencies."

Second, regarding the importance of technical aspects of foreign currency trading such as the derivatives-related activities, I would agree with Mr. Kiekens and Jonáš that there are grounds for cautioning against viewing such activities as a fundamental cause for high volatility. More generally, one needs to be careful not to put too much emphasis on the potential destabilizing impact from the use of such instruments. In addition to the elements mentioned by the staff, increased use of derivatives may have contributed to an improvement in the functioning of the markets by giving investors a better opportunity to spread the risks associated with volatility.

However, I realize that derivatives may have reduced the transparency of market positioning, and hence raised risks, for example by reducing the ability of both regulators and market agents to interpret markets signals, and to control risk adequately. Nonetheless, I prefer that supervisory policies concentrate on covering various types of risks rather than various types of financial instruments.

Third, I found the section on the problems with the Japanese banking sector to be very informative and would also like to thank Mr. Mesaki for his very useful update of the situation.

There are several similarities between the reasons for the problems in the financial system in Japan and the banking crisis experienced in several Nordic countries, including a rapid credit expansion and growth and, subsequently, a significant fall in real estate prices. t may also be right, and I would think so in most of the cases of banking problems that we frequently are confronted with in Board discussions on Article IV consultations, to point to a combination of factors underlying the problems that often includes factors such as "bad luck, bad policies,and bad banking."

Prevention of such crises is not an easy task, and solving the crises may require substantial efforts that often have to be designed on a case-by-case basis. part from the importance of having sufficient supervision and regulation, one of the lessons that could be drawn from experiences in some of the countries in my constituency is that openness in defining the situation of the banking system, and the announcement and implementation of clearly defined strategies to solve the problems contribute to a timely restoring of confidence. This point has also been emphasized by many others in today's discussion.

Against this background, I agree that a more structured and comprehensive policy stance on the resolution of Japan's financial system problems is called for at this stage. I welcome that the Japanese authorities share this view and look forward to the efforts under way as reported in Mr. Mesaki's helpful statement. I would also like to welcome that the size of the so-called "Japan premium" has decreased significantly, probably in response to a somewhat reduced uncertainty regarding the handling of the financial problems. Thus, more generally, there is an equally strong need for information from the financial institutions as there is for more information flowing to such institutions.

Furthermore, the depreciation of the yen, a somewhat more expansionary fiscal policy stance, a recovery in stock prices, and very low interest rates will hopefully lay the ground for a rebound in the Japanese economy. Eventually, when the economy recovers, non-performing loans and unrecoverable losses due to declining asset prices will be reduced.

Turning to the fourth issue proposed for discussion, I agree with Mr. Kiekens and Mr. Jonáš that recent developments in emerging markets clearly shows that the international capital markets are behaving in a largely rational manner and that they generally reward sound fundamentals, especially if we interpret this concept in a broad context that includes uncertainties surrounding future policy directions and gives due attention to the track record. Finally, I can agree with Mr. Shaalan that an important factor behind the more sizable capital flows to most Asian countries compared to Latin American countries might well be the higher rate of domestic savings in those countries. Accordingly, policies that promote private savings in Latin America could have a stabilizing effect on both interest rates and exchange rates by reducing these countries' dependence on capital inflows.

Mr. Rouai made the following statement:

We join other Directors in commending the staff for another valuable contribution to our understanding of the complex and dynamic evolution of the international capital markets. We would like to make the two following short comments on the interaction between macroeconomic and financial stability and on the Japanese banking system.

First, while a process of mutual interactions between various segments of the market has reinforced the strength of the forces of liberalization and innovation in the international capital market, effective multilateral cooperation and coordination in regulation and supervision have not kept pace with the rapid developments characterizing the market. We welcome the work of the Basle Committee in this area, but as in previous occasions, we see an important role for the Fund in this task in view of the direct link between macroeconomic stability and financial solvency. The staff may wish to comment on the potential contribution that the Fund can make in this regard.

Second, we commend the Japanese authorities for the careful and comprehensive steps they have taken and are contemplating in order to restore stability and strength to the financial system of Japan. We welcome in particular their aggressive attitude toward the disclosure by Japanese banks of information about problem loans. In this connection, although our preference was for the publication of the interim report, we consider that the point raised by Mr. Mesaki is a valid one and we can therefore support his proposal.

Mr. Vernikov made the following statement:

I welcome the staff paper, which is well focused on developments and policy issues of core importance. While I endorse the main points of the appraisal, let me make some brief remarks on a number of separate subjects.

While I note that the staff shares the belief about misalignment between exchange rate movements last Spring and macroeconomic fundamentals, it is highly commendable that we can look into the technical mechanisms in the market that are believed to have contributed to the magnitude of the misalignment. I noted the doubts expressed by a number of directors with regard to the impact of the technical aspects of trading on the volatility of forex markets. Nevertheless, I congratulate the staff for bringing to our attention an intellectually interesting hypothesis, and I would encourage the Research Department to keep on doing so in the future.

As regards emerging capital markets, I endorse the two main findings of the staff analysis, namely that the slowdown in net capital flows was accounted for entirely by portfolio flows, and second--that it was primarily capital flows to Latin America that slowed down. Asian markets have performed well this year with regard to both foreign direct and portfolio investment. These features once again underscore the conclusion that markets can finally make pretty adequate judgments about the soundness of fundamentals in this or another country. I, therefore, join those directors who supported a point by Messrs. Kiekens and Jonáš that international capital markets had behaved in a largely rational way.

As for the Japanese banking sector problems, the need to consolidate financial institutions, to strengthen supervision, and to enhance competition is obvious. At the same time, there is the issue of the use of public funds in the restructuring of troubled institutions. In his helpful opening statement, Mr. Mesaki mentioned that the Bank of Japan may provide loans to Jusen--housing loan companies. It would be useful to know if the Japanese authorities have earmarked a definite amount of public funds for these purposes, and whether it may cause moral hazard problems for the future operation of the Japanese banks and housing loan companies.

Departing for a minute from the text of the staff report, let me say that reading economic periodicals prompts mention of a number of other important developments we may need to look at. Let me mention just a couple of such.

One can read that, after a period of high growth in the U.S. stock market lately, the trend could change swiftly in 1996. Does the staff recognize this probability and how is it going to affect financial markets worldwide?

There are indications that in the U.S. the banking industry is losing relative importance within the financial system. Banks' and thrifts' share in the total financial assets of financial institutions is reported to have fallen from 54 percent in 1980 to less than one-third in June 1995. Over the same period the share of consumers savings kept with banks decreased by one-half. If that is really the tendency, we may need to monitor more closely the activities developed by mutual funds and other nonbank institutional investors.

Mr. Shields made the following statement:

My views differ from those of many other Directors on the usefulness of the current exercise. The calls made at previous discussions for more analysis on capital market developments and capital account issues were focused on the need to examine capital market issues in the context of discussions on individual countries. Therefore, I am doubtful about whether an interim report on capital market developments would, in itself, be helpful.

Capital market developments are routinely examined in the context of the world economic outlook exercise and the periodic sessions on world economic and market developments. Thus, it might be more useful for the staff to prepare additional material on capital market developments for consideration at those discussions than to have separate discussions on this topic. This consideration also has a bearing on the question of whether the staff paper for the current discussion should be published. Although I have no objections to its publication, the staff paper for the current discussion should not serve as a precursor to future documents of this type.

Like many other speakers, I think the staff paper exaggerates the importance of knock-out options. Again, it just displays the general arguments emphasizing the importance of such options . This subject is less critical than the staff paper suggests, and perhaps the insertion of some material from Mr. Clark's statement would help produce a more balanced assessment.

I agree with Mr. Esdar that the usefulness of foreign exchange intervention by central banks depends on whether such interventions support appropriate policy actions. When they do, they may be able to move markets perhaps earlier or more forcefully than would otherwise have been the case. But there are limited circumstances in which coordinated intervention works.

On emerging markets, I agree with other speakers that markets seem to be pressing bonds much better on the basis of individual country risk. This is a welcome development. I just hope that markets do not forget too early the lessons of the past year or so.

As to the impact of domestic savings on bond finance, the level of savings may or may not have an impact on total volumes, but clearly higher levels of domestic savings act in favor of lower spreads, all other factors being equal. As to the question about availability and price, there is a lesson to be taken from the availability of Fund financing. At the present juncture, Latin American borrowers are maintaining market access, albeit at higher prices, This is clearly a success for private capital markets in general. It means that there is less need for official finance.

As to the effects of the Mexican crisis, Mrs. Cheong was correct to note the numerous factors that are likely to be affecting both the current levels of activity in equity markets and what happened to them in 1994. I agree with her that they bring into question the judgment that these markets have not yet returned to normal.

We have discussed Japan recently in the context of both the world economic outlook exercise and the session on world economic and market developments. Nevertheless, like other Directors, I would like to emphasize a few points for the current discussion.

First, the recent improvement in disclosure will certainly help to reassure the international community. Second, it is essential that the authorities show that they can deliver a solution to the banking problem by the end of this year, including the use of public money. Third, we have already remarked that, while both the Daiwa affair and the problem of nonperforming loans raise issues of transparency, they are separate problems. Fourth, when we were looking at the question of premia faced by Japanese banks, I would have thought the biggest single factor was doubt about whether the authorities will be able to deliver on their commitment to sort out problems and provide support in the meantime, and that makes it all the more important that further action is taken soon.

Finally, I welcome the reference to the Windsor Declaration in the staff paper. The Declaration itself is a sensible statement of steps that need to be taken to improve regulation of derivative markets. The staff paper focuses appropriately on monitoring large exposures, which should help to reduce the chances of further collapses, such as that of Barings, and the segregation of client money, which should improve the orderly resolution of bank failures in the future.

Mr. Giulimondi made the following statement:

We find it quite convincing--and in a sense unavoidable--that the fundamentals have driven the basic trends in exchange rate and asset pricing markets. That technical trading and derivative finance may have increased volatility along the path mapped out by the underlying economic fundamentals in major industrial countries is also possible and unsurprising. Rather, it is worrisome and worth further analysis that derivative instruments in developing countries may be used to circumvent restrictive regulations and may have contributed to precipitate the Mexican crisis.

The positive role played by derivatives is out of question as it is demonstrated by their staggering growth itself. However, supervisory and regulatory authorities' need to effectively deal with the risks inherent to derivative instruments is still largely to be addressed. These transactions are off-balance-sheet, easily leveraged, suitable to be engineered in complex schemes, faster than traditional finance, monitored with difficulty by external and internal controls, and sometimes influenced by a gambling tendency of loosing money traders. As a consequence, balance sheets can hardly provide a reliable picture of the actual risks assumed by financial operators. In addition to that, the nature of banking is changing, by shifting from less profitable traditional lending to securities markets and triggering a process of consolidation in financial intermediation, which is taking place both among banks for lending activities and between the lending and the securities industries.

As the establishment of higher capital ratios by the Basle Capital Accord indirectly provided incentives for off-balance-sheet and potentially riskier transactions, the new supervisory approach of the Basle Committee tries to adapt prudential capital requirements to the risk assessment performed by individual banks themselves. Increasing international coordination among regulatory bodies and different marketplaces is also needed. In fact, given the earning pressures vis-à-vis share-holders faced by institutional investors and money managers, overly aggressive strategies--through either lower lending risk standards or speculative positions in the securities markets--can be discouraged through adequate information [Windsor Declaration]. The next staff report could be an opportunity to examine recent trends in market regulation, such as the attempts to create clearing houses for over-the-counter, less standardized derivative transactions.

Concerning the banking difficulties in Japan, potential danger currently exists in terms of the effects that heightened difficulties could exert on the incipient international recovery and international liquidity. The situation seems manageable and the Bank of Japan's strategy of maintaining a low level of interest rates seems appropriate and consistent with the general downward shift in the industrial countries' interest rates structure. However, a cooperative and courageous approach is needed in highly-internationally-integrated financial markets where, almost by definition, there are no truly domestic crises. This is particularly true in this case. There is a strong need for accelerated regulation, surveillance, and rationalization. In fact, the persistence of a premium for Japanese banks does not only reflect market uncertainties about supervision, disclosure standards, and sources for provisioning and writing-off bad loans, but, also, negatively affects banks' profitability and delays their rehabilitation.

Finally, regarding the recent trends in the emerging markets, investors seem to have been reassured by the firm adherence to sound policies and the defense of the exchange rates displayed by the countries concerned in the aftermath of the Mexican crisis. In this respect, the disintermediation of commercial banks and the corresponding increase in bond and equity financing have ultimately diversified capital flows' composition and seem to have lessened moral hazard problems and incentives for defaulting, as a restructuring of external debt would now be much more difficult in the case of crisis than it was in the past. governments and markets appear to be more sensitive to domestic economic conditions and policies.

As concerns the after-effects of the peso crisis, the general policy prescription to increase domestic savings in order to reduce the level of external indebtedness and the cost of the access to capital markets is unquestionably valid. In this light, increased recourse to short-term capital and heightened fragility of the banking system in a number of developing countries must be closely monitored. Also, the intensified recourse to sovereign credit guarantees in international bond issues should be kept under close scrutiny as it might cause risk-camouflage and favor inadequate levels of risk exposure in absolute terms and/or excessive concentration of risk in public hands.

Mr. Mesaki said that it might seem odd that Japanese banks were continuing to pay dividends, despite the nonperforming loan problem. However, according to the tradition of Japanese banking practices, a failure to pay dividends would be akin to an announcement of failure. Although the Japanese authorities were not in a position to direct the dividend policies of the banks, some banks had recently begun to make changes in their policies. Additional, more drastic changes could come about over the course of the coming financial year, as further progress was made on the burden-sharing of banking losses. However, the most important matter at the present stage was to restructure the banking institutions in a manner that would enhance their effectiveness.

The relationship between the use of public money and the housing loan corporation in resolving the banking sector problem was at the heart of the discussion currently under way in Japan, Mr. Mesaki stated. The key issue was to determine the most appropriate way to share the burden of losses between the banks and the lenders, especially the agricultural cooperatives. It was to be hoped that these matters would be resolved in the context of the fiscal budget for 1996/97.

Mr. N'Guiamba made the following statement:

> The staff papers provide a very useful picture of developments, prospects, and key policy issues in the international capital markets since the previous discussion. We understand from the staff paper that developments in international capital markets during the period under review have been influenced by various factors, including the effects of the Mexican crisis and the existence of large short-term movements of exchange rates of major currencies. Most emerging market countries in Asia seem to have been able to fully recover from the difficulties they experienced following the Mexican crisis, while Latin American countries are still trying to get back to the levels of financial activity and price performance that prevailed before the crisis. The situation of Latin American countries is said to have resulted partly from problems faced by their banking sectors. We would like to encourage these countries to take additional measures that will improve the functioning of their financial systems.
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> There has been renewed access of developing countries to international capital markets. It is particularly comforting to learn that the large spreads between interest rates on bonds issued by developing countries from the U.S. Treasury that resulted from the Mexican crisis have been narrowing. We also welcome the fact that in recent months short-term interest rates have fallen to their pre-crisis levels in most emerging market countries. In that context, we wonder whether the staff could comment on the movement of short-term interest rates elsewhere in the developing world, especially in African countries.
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> As to the movement of exchange rates, economic fundamentals and other factors have played an important role in the weakening of the dollar vis-à-vis the yen. However, it is difficult to evaluate the importance of derivative-related activities in this process.

We welcome the coordinated market intervention on the part of Japan, the United States, and Germany to correct the misalignment of dollar-related exchange rates in the recent past. Additional efforts are needed to minimize the degree of volatility in the foreign exchange markets in general, because a high degree of volatility in these markets can effect asset developments in bond equity derivative markets and, thereby, slow economic growth in the global economy.

On the problems facing the banking systems of some countries, we welcome the recent initiatives by a number of Latin America countries. However, it is worrying to note from the staff paper that despite these initiatives, banking systems remain weak and vulnerable in some of these countries. The case of Japanese banks appears to be more serious, given the importance of this country in the global economy. We note from the staff paper that Japanese banks are facing asset availability problems that resulted from the rapid expansion of loans backed by real estate during the 1980s. We are pleased to note that the Japanese authorities are actively looking for suitable solutions to this problem and we encourage them to continue their efforts in this area. We agree with the staff that the lack of transparency in financial disclosure in Japanese banks must be dealt with as quickly as possible. In that context, it is necessary for the Japanese authorities to bring the transparency and disclosure requirements up to international standards.

The staff representative from the Research Department stated that the staff did not doubt the accuracy of the Japanese Ministry of Finance's estimates on problem loans. However, there were differences in the way in which "nonperforming loans" had been defined by the Ministry of Finance and by private analysts. For that reasons, the estimates prepared by private analysts included several categories of assets that were not included in the Ministry of Finance's official estimates. It should be emphasized that it was not the total amount of nonperforming loans, but the size of the eventual loss that might result from those loans, that was important.

The staff's analysis on the Japan premium was based on an examination of the timing of changes in interest margins in the syndicated loans market, the staff representative said. Although many aspects of the "Japan premium" remained a puzzle, the premium had declined significantly over the past few weeks since the staff paper was circulated. Many analysts considered that that decline reflected market expectations of a resolution of the banking problem following the release of the final report of the Financial System Stabilization Committee of the Ministry of Finance on December 22, 1995. According to that explanation, the market was, again, expected to act ahead of the authorities.

As the staff paper indicated, there are three sociopolitical factors to be taken into account with respect to the potential use of public funds in resolving the banking problem, the staff representative noted. First, it was not clear that there was widespread support for the use of public funds to help cover loan losses. Second, the financial institutions concerned were not necessarily in favor of resorting to the use of public funds, as that would entail an admission of failure on their part. Third, although there was clearly a need to protect small depositors, it would be important to avoid problems of moral hazard in "bailing out" failed institutions.

As Directors' comments for the current discussion demonstrated, the questions related to the merit of intervening in foreign exchange markets were controversial, the staff representative commented. Nevertheless, experience seemed to indicate that such intervention was most likely to be successful in cases where it was aimed at signalling the future course of policies and when it was followed up by appropriate policies to "push" the markets forward, rather than to try to move the markets onto a different path. Clearly, more work was needed to gain a better understanding of the effects of market intervention.

Another staff representative from the Research Department noted, with respect to the short-term conditions in derivatives markets vis-à-vis fundamentals in determining movements in exchange rates, that developments in the currency options market during the week of April 17, 1995 had contributed to the unprecedented appreciation of the yen from ¥84 to the dollar to ¥79.75 to the dollar. However, that appreciation--which had been very short-lived--had been easily reversed by intervention by the Bank of Japan and the U.S. Federal Reserve. That experience showed that economic fundamentals determined the underlying direction taken by the markets, while technical conditions contributed to short-term movements. That conclusion was in line with the general findings of available research on excess volatility, which suggested that sudden, sharp changes in asset prices were often difficult to explain on the basis of fundamentals. However, at the present stage, it was not possible to project the size of the impact that technical factors, like intervention, could have in quantitative terms.

Moreover, it was not clear that short-term volatility was necessarily harmful, the staff representative commented. Most market participants monitored developments in a way that allowed them to avoid suffering significant adverse effects stemming from short-term volatility.

As to the need for enhanced international cooperation and disclosure in the face of increasing globalization, it should be noted that market regulators had recently agreed on a set of principles for consultation and cooperation, as set forth in the Windsor Declaration, the staff representative said. In addition, the Governors of the Group of Ten had recently agreed on a net set of capital standards that was different than those already embodied in the Basle Capital Standards; the implementation of the new standards was to take place over the coming two years. Moreover, efforts to enhance cooperation between the International Organization of Securities Commissions and the Basle regulators were progressing. Nevertheless, a number of important issues remained concerning the comprehensiveness of the agreements currently in place, in particular with respect to the role of the emerging markets. The Fund staff was closely collaborating with the Bank for International Settlements and major central banks on those issues. The staff hoped to include analyses of the issues related to international cooperation in forthcoming papers on international capital markets.

The staff was not in a position to comment on the extent to which the steeper slope of the deutsche mark yield curve compared with the dollar yield curve might be a refection of the so-called EMU premium, the staff representative stated. The current juxtaposition between those yield curves could be attributable to a number of factors, including differences in monetary conditions, economic growth, and exchange rate expectations in Germany and the United States, as well as in their current cyclical positions. The intention of the staff paper was to report to the Board on the most frequently heard explanations for that difference among market participants, including the major deutsche market trading houses.

With respect to the difference between the Eurodollar rate and the rate on U.S. treasury bills, it should be noted that Eurodollars and U.S. treasury bills were very similar in terms of maturity, liquidity, taxes, and settlement procedures, the staff representative commented. The spread between those instruments was not affected by changes in supply and demand, owing to the extensive arbitrage possibilities. In the light of those considerations, the residual difference between them was generally seen as a risk premium attributable to bank deposit rates in the United States.

The growth of syndicated lending to developing countries was, at least partly, a reflection of increased competition and narrower spreads in lending rates, coupled with the improved capital positions of banks, particularly in the United Kingdom and the United States, the staff representative from the Research Department considered. Over recent years there had been a significant increase in syndicating lending for infrastructure building in the developing countries, which were attracted to that type of financing, owing to the greater flexibility it provided in terms of structure and maturity. The staff did not see the growth of syndicated lending as being attributable to any shift away from off-balance sheet activities toward on-balance sheet activities.

Mr. Abbott recalled that at least one speaker had indicated that there was a symmetric EMU discount in France, Belgium, Luxembourg, the Netherlands, and Italy. Had there been any examination of that phenomenon?

Mr. Cailleteau asked whether the staff could comment on whether the policy mix in Japan was consistent with the recent interventions by the Bank of Japan, and whether the direct intervention aimed at increasing liquidity was likely to have any negative impact on the economy as a whole.

The staff representative from the Research Department responded that the staff was not aware of any study on a symmetric EMU discount in European countries.

The current monetary policy stance in Japan was not inconsistent with the overall direction of macroeconomic policy, the staff representative from the Research Department considered. The authorities were currently acting to push the value of the yen and interest rates down, which would tend to increase liquidity. However, thus far no signals of overheating were apparent. Indeed, the rate of inflation had remained flat over recent months, despite the rapid increase in the growth of monetary aggregates.

The Chairman made the following summing up:

Executive Directors welcomed the opportunity to discuss developments in international capital markets on a semiannual cycle. They viewed this discussion as an effective additional tool for monitoring systemic financial issues and for enhancing Fund surveillance over international capital markets. Several speakers also noted the importance and scope of integrating the staff's work on capital markets with the bilateral surveillance over members' macroeconomic policies. There was a broad consensus among speakers that the markets had performed remarkably well despite increased exchange rate volatility and the problems in emerging markets in early 1995.

Many Directors remarked on the sharp changes in exchange rates between the major currencies during 1995. A number of Directors considered that observed changes in fundamentals in 1995 did not warrant the changes in exchange rates. Some speakers noted that technical factors and trading conditions in currency-related derivative markets may have played a role in the yen/dollar market in March and April 1995, but it was difficult to quantify the importance of these factors. Speakers generally agreed that, in certain circumstances, intervention in foreign exchange markets by the major central banks could play a useful role in providing some direction to the markets.

Directors referred to the increase in volatility in securities and derivative markets. At the same time, they observed that developments in the major bond and equity markets had continued along favorable trends, which could be attributed largely to appropriate economic policies that had contributed to sustainable growth rates, low inflation, and relatively low interest rates in major industrial countries.

Several speakers noted that profit margins on both domestic and international bank loans--as measured by the spreads between loan and deposit rates--had declined to the lowest point in recent years, suggesting a high degree of competition among banks both within and between the major banking centers. Some bank regulators had recently raised concerns that lending standards and loan covenants had been relaxed too much and that similar competitive pressures in the past had driven banks into unfamiliar and riskier lines of business. Directors stressed that bank supervisory authorities in the major countries should remain vigilant to ensure that undue risk-taking is avoided.

In discussing the performance of the emerging capital markets, Directors observed that some of the markets that had been hit immediately after the Mexican crisis had more recently experienced sustained recoveries in financial activity and asset prices. Capital inflows had recovered to some extent from the declines experienced in 1994 and early 1995, but the level of aggregate inflows to developing countries could be expected to remain below the levels seen in 1993-94 for some time. Directors observed that significant differences remained in access to international markets between most of the Asian and several Latin American countries, and they attributed this to differences in fundamentals and to greater discrimination by investors. It would be premature to say that all emerging markets, particularly those outside Asia, had fully recovered. Speakers referred to several important lingering effects of the crisis. First, interest rate spreads are still significantly higher than before the crisis in the largest countries in Latin America. Second, credit guarantees have become more prevalent, and more than three quarters of all developing country international bond issues have been sovereign issues. Third, maturities have shortened considerably. Fourth, investor interest in emerging market securities has not rebounded to pre-crisis levels across a broad spectrum of markets in Asia and Latin America.

Several Directors expressed concern about the weaknesses in banking systems in a number of countries. They welcomed the reforms that many of the affected Latin American countries are implementing, and stressed that this effort has to be sustained. It was noted that many of these banking systems have been left with impaired capital positions and substantial levels of nonperforming loans. These banking systems are likely to remain vulnerable for some time, and Directors underlined that transparent and sound financial systems, with comprehensive supervision, are essential for the maintenance of stable macroeconomic policies.

Some Directors commented that the effective enforcement of prudential regulations in some emerging markets is being made significantly more difficult by the ability of domestic financial institutions to use derivative transactions offshore to offset the effects of domestic financial regulations. Some Directors noted that, in light of the increased use of these instruments, the regulatory authorities should require improved financial reporting, supervision, and risk management.

Directors generally agreed that the Japanese monetary authorities stand at a critical juncture in deciding how to resolve the long-standing banking difficulties. Many speakers welcomed the fact that the Japanese authorities had signaled a more aggressive stance toward resolving this problem by allowing some banking institutions to fail and by taking some other actions recently. Speakers welcomed the reassuring information provided by Mr. Mesaki. However, there was a broadly shared feeling among Directors that other measures will be necessary. In particular, a number of Directors thought that faster write-offs of non-performing loans, greater use of public funds, and increased efforts to sell bank assets will be needed to achieve an early resolution of the bad debt problem. Several Directors also recommended improved transparency and more stringent disclosure requirements.

Many Directors considered that the premium paid by the Japanese banks in the interbank market reflected concerns in international markets about the slow progress in resolving loan losses by Japanese financial institutions. The recent problems at Daiwa had magnified these concerns, although most Directors regarded the problems at that bank as an isolated incident. Nevertheless, Directors, referring to the large international differences in financial disclosure, accounting standards, bank supervision, and management practices, emphasized the need for greater international harmonization, cooperation, and sharing of information among the major industrial countries.

This was a wide-ranging discussion, and I note the view of many Directors expressed in this meeting that a semiannual discussion of developments in international capital markets is useful and productive. The staff, therefore, will prepare the usual papers for the annual Board discussion on international capital markets in mid-1996 and another interim paper for discussion at end-1996. We would not intend to publish this paper on interim developments; the substantive issues will be covered in the next full set of papers in June 1996, which will be published.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/117 (12/11/95) and EBM/95/118 (12/13/95).

4. JORDAN - EXCHANGE RESTRICTION - EXTENSION OF APPROVAL

The retention by Jordan of the exchange restriction evidenced by arrears on certain external debt service payments is approved until Executive Board consideration of the envisaged request by

Jordan for an extended Fund arrangement or February 29, 1996, whichever is earlier.

Decision No. 11142-(95/118), approved
December 12, 1995

5. MAURITANIA - EXCHANGE RESTRICTION - EXTENSION OF APPROVAL

The retention by Mauritania of the exchange restriction evidenced by external payment arrears is approved until the next Article IV consultation with Mauritania or March 31, 1996, whichever is earlier.

Decision No. 11143-(95/118), approved
December 12, 1995

6. ZAMBIA - EXCHANGE RESTRICTIONS - EXTENSION OF APPROVAL

Zambia continues to have exchange restrictions on debt service payments evidenced by limitations on payments for external debt. The Fund grants approval for the retention of the exchange restrictions until April 30, 1996 or completion of the next Article IV consultation with Zambia, whichever is earlier.

Decision No. 11144-(95/118), approved
December 12, 1995

7. ZIMBABWE - EXCHANGE RESTRICTION - EXTENSION OF APPROVAL

Zimbabwe has an exchange restriction arising from the blocking of dividend and profit payments accrued on investments made before May 1993; and a multiple currency practice, arising from existing contracts under the forward foreign exchange scheme previously operated by the Reserve Bank of Zimbabwe. The Fund grants approval for the retention of the exchange restriction and multiple currency practice until February 29, 1996 or until the completion of the next Article IV consultation with Zimbabwe, whichever is earlier.

Decision No. 11145-(95/118), approved
December 12, 1995

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 94/36, 94/109, 94/110, 95/3, 95/4, 95/6, and 95/8 are approved.

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/196 (12/8/95) and EBAM/95/198 (12/11/95) and by an Assistant to Executive Director as set forth in EBAM/95/197 (12/7/95) is approved.

10. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/95/107 (12/11/95) is approved.

APPROVAL: May 12, 1997

REINHARD H. MUNZBERG
Secretary