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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/78

10:00 a.m., July 28, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	J.G. Borpujari, Temporary
	A. Fayolle
	P.-M. Fremann, Temporary
T.A. Bernes	
B. Esdar	O. Schmalzriedt, Temporary
E.R. Grilli	L. Pinzani, Temporary
	J.N. Santos, Temporary
	J.P. de Morais
	T. Berrihun, Temporary
D. Kaeser	W.H. Gruber, Temporary
	H. Kaufmann, Temporary
A. Kafka	H.F. O'Brien
W. Kiekens	N, Goffinet, Temporary
	M. Nemli, Temporary
K. Lissakers	B. S. Newman
	D.G. Loevinger, Temporary
	T.T. Schneider, Temporary
	M.A. Hammoudi, Temporary
	S. Rouai, Temporary
	L. Palei, Temporary
	J. Shields
A.S. Shaalan	Y.Y. Mohammed
	H.B. Disanayaka
	R. Kannan, Temporary
	R.P. Watal, Temporary
	A.R. Palmason, Temporary
G.F. Taylor	O. Kwon
	A.G. Yakub, Temporary
J.J. Toribio	E. Rodríguez, Temporary
	Y.G. Yakusha
	A. Levy, Temporary
K. Yao	A. Barro Chambrier
	K. Kpetigo, Temporary
	H. Ono
	D. Fujii, Temporary
	S. Joyosumarto
	Phan M.H., Temporary
	Han M.
	Zhang F., Temporary
	Lai K., Temporary
A.G. Zoccali	

R.H. Munzberg, Secretary
A. Mountford, Acting Secretary
S. Bhatia, Assistant
D.J. de Vos, Assistant

Also Present

IBRD: G. Bartoli, A. Bassani, O.A. Meesook, Africa Regional Office. African Department: G.E. Gondwe, Deputy Director; A. Basu, Deputy Director; A.I. Abdi, K.J. Cady, D.T. Coe, S.M. Darbar, M.W.E. Desclercs, J.E.J. De Vrijer, I.A.D. Diogo, M. Fouad, C.A. François, N.M. Henstridge, S.M. Hossain, R.D. Kibuka, P.C. Peroz, P.C. Rother. Asia and Pacific Department: D.J. Goldsbrough, M.R. Kelly, C.M. Towe. European I Department: M.J. Fetherston. European II Department: D.J. Donovan, I. Kapur, T.O. Saavalainen. External Relations Department: S.J. Anjaria, Director; F. Baker, C. Hellemaa. Fiscal Affairs Department: H.T. Young. Legal Department: H. Cissé. Policy Development and Review Department: J. Ferran, Deputy Director; M.D. Cerisola, D. Desruelle, O. Havrylyshyn, B.R. Kahn, R.H. Nord, S.M. Nsouli, C.R. Shiells, P. Sorsa. Secretary's Department: P. Gotur. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, A.J. Tweedie. Statistics Department: C.C. Carson, Director; A.A. Bloem, F. Maitland-Smith. Treasurer's Department: F.M. Lakwijk. Western Hemisphere Department: C.M. Loser, Director; T.M. Ter-Minassian, Deputy Director; M.E. Bonangelino, Deputy Director; B.C. Stuart, Deputy Director; J.D. Cole, S.V. Dunaway, C.F. Kramer, M. Leidy, A.S. Linde, R.M. Salgado, S.P. Tokarick. Office of the Managing Director: M. Russo, Special Advisor; O.J. Evans. Advisors to Executive Directors: M. Askari-Rankouhi, O.L. Bernal, J.A. Costa, L.J.F. Erasmus, P.M. Fremann, A. Giustiniani, K.M. Heinonen, G.M. Iradian, J. Jonáš, M.F. Melhem, H. Mori, J.-C. Obame, H. Ogushi, O. Otazú, O. Sein, M. Sobel, T. Turner-Huggins, L.B.J. van Geest. Assistants to Executive Directors: W.F. Abdelati, M.A. Brooke, K.S. Brownlee, C.K. Duenwald, M.H. Elhage, J.C. Estrella, D. Giga, R.J. Heinbuecher, J.K. Honeyfield, E. Jourcin, K. Kask, M. Kell, E. Kouprianova, K. Kpetigo, J.P. Leijdekker, A. Lucenti, J. Mafararikwa, S.D. Melese-d'Hospital, D. Merino, T. Presečan, G.P. Ramdas, D. Saha, U.Y. Tilyayev, Zubir bin Abdullah.

1. REPORT BY ACTING MANAGING DIRECTOR

The Acting Managing Director made the following statement:

During the period of July 18–25 I visited Azerbaijan, Latvia, and Moldova to get acquainted with key policymakers and familiarize myself with the countries' economic situations. I was very warmly received by the authorities in each country, and they all expressed their appreciation for the good relations with the Fund.

In Azerbaijan, I met with the president, Mr. Aliyev, and prime minister, Mr. Rasizade, and many other senior officials of the authorities. In addition, I had meetings with the members of the business community and representatives of the political opposition. I was very impressed by Azerbaijan's macroeconomic performance. The price level has remained more or less stable during the first half of 1997. The nominal exchange rate was appreciating steadily and real output was growing at about a 5 percent annual rate. Fiscal and monetary policies had been held within the limits of the economic program supported by the Enhanced Structural Adjustment Facility and the Extended Arrangement. The authorities appeared fully committed to maintaining sound financial policies. They recognized that economic reforms in the last two years had borne fruit, and the ownership of the Fund-supported program was strong. This point was emphasized by President Aliyev himself. The authorities stressed that institutional reforms were key to future economic success, and the vestiges of the old state had to be removed. Privatization, reforms of the state banks, government restructuring, and the ongoing removal of commercial functions from the ministries were bringing progress in this area.

I noticed the strong role of the president in controlling economic policy. He said that while Azerbaijan was considered a late reformer, it had recently taken very bold steps, such as the elimination of the utility privileges and the increase of the pension age, which had won recognition abroad, including from Mr. Chubais, the first deputy prime minister of the Russian Federation. The central bank was ultimately responsible to the president for its policies, but it was relatively independent in setting targets for monetary and exchange rate policies. The governor said that the central bank's independence was buttressed by the existence of the Fund-supported economic program. I expressed my concern about the weakness of the banking sector and stressed the need for rapid progress in the operational restructuring of the state banks, and the recapitalization and privatization. Similarly, I emphasized that timely repayment of Azerbaijan's external debt was critical for the country's international reputation and uninterrupted financial relations with the Fund. Finally, as the Minsk Group of the Organization of Security and Cooperation in Europe was in Baku to discuss the Nagorno-Karabakh peace process, I emphasized that there was tremendous potential for regional economic cooperation once the peace process was completed. President Aliyev agreed that it was very important to reach a rapid settlement on the Nagorno-Karabakh issue for political, economic, as well as moral reasons.

In Riga, Latvia, I met with the prime minister, Mr. Skele, the finance minister, Mr. Zile, the governor of the central bank, Mr. Repse, and the head of the privatization agency, Mr. Naglis. A mission was in Riga at the same time to conduct discussions on a possible successor Stand-By Arrangement. There is a considerable amount of political uncertainty at present. On July 25, the three major coalition parties decided to withdraw from the government, and the prime minister, a businessman with no political affiliation, has submitted his resignation today. I expect he will remain acting prime minister at least for the time being. In the absence of a counterpart, it is likely that the mission may not be able to conclude the program discussions at this stage. Regarding external relations, the authorities expressed their dissatisfaction at the recent decision by the European Commission not to recommend that Latvia be included in the first group of countries with whom discussion would begin about entry into the European Union. Macroeconomic developments, however, appear quite favorable. Real GDP grew by nearly 3 percent in 1996 and is expected to increase by 4 percent this year. The 12-month rate of inflation through June 1997 was 7.5 percent; although the current account deficit widened to nearly 8 percent of GDP in 1996, strong capital inflows resulted in an overall balance of payments surplus. All performance criteria of the Fund-supported program were observed at end-June 1997. On fiscal policy, the authorities indicated that it was difficult to withstand the growing pressure to increase government spending. In particular, there is a need to augment public investment. On monetary and exchange rate policy, Mr. Repse indicated that the exchange rate peg to the SDR had proved to be a very effective nominal anchor. Despite the real effective appreciation, there was still an adequate margin of competitiveness for tradable goods. In part owing to a rebound in wood exports, the current account deficit is expected to narrow considerably in 1997. Even though interest rates have fallen substantially, sizable capital inflows are still taking place and large foreign direct investments are expected. Monetary policy is likely to remain tight. I emphasized the need to accelerate structural reforms, in particular in the area of privatization of enterprises and apartments, as well as land reform, in order to encourage domestic and foreign investment, and ensure sustained economic growth. With respect to privatization, the authorities reiterated their commitment to complete divestment, including of the large enterprises, by mid-1998. I noted the considerable progress made in this area in the past few months. On trade policy, however, the prime minister was reluctant to commit to any further agricultural tariff reductions given the considerable reduction that took place on July 1, 1997, as well as the higher level of agricultural protection in Europe.

In Moldova, I had productive meetings with the president, Mr. Lucinschi, the prime minister, Mr. Ciubuc, the parliamentary chairman, Mr. Motpan, and other senior officials of the authorities, as well as with members of the financial, business, and diplomatic communities. They all expressed their appreciation for the Executive Board's decision on July 16 to support the reform process in Moldova by completing the second review of the EFF-supported program. I was impressed by the strong commitment to reform by the new government, the president, and the chairman of the parliament. All stressed that the reforms were irreversible and would continue during the second half of 1997 despite the pressures of parliamentary elections, which will take place no later than February 1998. During my visit, the law establishing tradability of agricultural land, the one prior action outstanding from the second review, received final parliamentary approval. During my discussions, I stressed the concerns expressed at the recent Executive Board discussion regarding the prospects for economic growth, the level of external debt, and the persistence of barter trade. The authorities confirmed that the prospects for this year's harvest were good, and that GDP growth for 1997 was expected to be 3 to 5 percent above the program projection of 1 percent. I stressed the need to maintain financial stability and effectively implement the recently agreed structural measures so as to underpin a sustainable medium-term recovery. Regarding external debt, I noted a widespread recognition of the risks of excessive borrowing, and was informed that there were no plans for any further external borrowing this year other than the World Bank's structural adjustment loan. I expressed concern about the extensive use of barter trade, especially in transactions with the energy sector, and stressed the importance of program understandings to phase out barter quickly and to move forward rapidly with privatization of the energy sector. I agreed with the Moldovan authorities that the mission currently in Chisinau would visit Transnistria for one day to meet for the first time with representatives of the Transnistrian administration and begin the process of collecting and analyzing data on the Transnistrian economy.

Finally, I would like to express my sincere appreciation to the offices of Mr. Kaeser, Ms. Srejber, and Mr. Wijnholds, and the respective authorities for making my visit most pleasant and productive.

2. REPORT BY ACTING MANAGING DIRECTOR

The Acting Managing Director noted that a staff mission had arrived in Thailand over the weekend. The finance minister of Thailand had informed the mission that the authorities wished to negotiate a Fund-supported program. The authorities had also indicated to the staff that they hoped to move rapidly to finalize a program, and the mission had already begun intensive negotiations. The Board would be kept informed of the status of the discussions as they proceeded. He would request that his announcement be kept confidential. The authorities had indicated that they would be making a public statement the following day of their intention to seek Fund support.

3. UNITED STATES—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with the United States (SM/97/177, 7/7/97). They also had before them a background paper on selected issues in the United States (SM/97/186, 7/14/97).

The staff representative from the Western Hemisphere Department made the following statement:

Since the staff report (SM/97/177, 7/7/97) was issued, there have been a number of developments in the U.S. economy. The Chairman of the Federal Reserve Board, Mr. Alan Greenspan, presented the biannual report to the Congress on the economic situation and monetary policy; further progress has been made in implementing the balanced budget agreement; and additional data have been released pointing to moderate economic growth in the second quarter of 1997 and the continuing absence of inflationary pressures. These developments do not change the thrust of the staff appraisal.

On July 22, Chairman Greenspan in testimony on the Federal Reserve's Monetary Policy Report to the Congress (Humphrey-Hawkins testimony) attributed the exceptional performance of the economy to possible basic improvements in long-term economic efficiency and to some temporary factors that have restrained inflation. Public policy also was credited with playing a role, as budget deficits have been curtailed, leading to a decline in interest rates, and deregulation in a number of industries has fostered competition and held down prices.

In particular, Mr. Greenspan stressed that the increasingly successful and pervasive application of recent technological advances, especially in telecommunications and computers, appeared to have boosted productivity growth. He also noted that a heightened sense of job insecurity, reflecting corporate restructuring and an increased fear of skill obsolescence, has held down wage demands, but this influence may diminish in the period ahead as labor markets remain tight. At the same time, changes in the health care industry have contributed to holding down the growth in the cost of benefits and, hence, overall labor compensation. In addition, increasing globalization has enabled greater specialization, allowing comparative advantage to hold down costs and enhance efficiency, while a strong U.S. dollar had restrained the growth in import prices and constrained the pricing power of import-competing firms.

Mr. Greenspan suggested that there appeared to be no immediate need to tighten policy. He indicated that economic growth in coming quarters was expected to slow to 2–2½ percent, a rate more in line with potential. The unemployment rate would stay around its current level of 5 percent through 1998. Consumer prices were expected to rise by 2¼–2½ percent in 1997, but would rise a bit more quickly in 1998 at a rate of 2½–3 percent, as the effects of factors contributing to holding down prices in 1997 (such as favorable movements in food and energy prices and appreciation of the U.S. dollar) diminish. However, Mr. Greenspan said that, given the uncertainties in the current economic situation, the considerable momentum in the economy, the relatively tight conditions in labor markets, and the lags in the response of the economy to monetary policy changes, the Federal Reserve had to be prepared to tighten monetary policy if conditions warranted. In particular, there was a risk that economic growth might be stronger than expected, reflecting the high level of business and consumer confidence and the run-up in stock market wealth, the full effects of which apparently have not been reflected in overall demand.

Market participants interpreted Mr. Greenspan's remarks as suggesting that the Federal Reserve would not move to tighten interest rates in the near term, stressing Mr. Greenspan's suggestions that the productive capacity of the economy had improved and that growth would slow to a more sustainable rate in the coming quarters. As a result, stock prices rose sharply in U.S. and world markets after Mr. Greenspan's testimony, and the yields on longer-term U.S. bonds declined significantly.

Both Houses of the Congress have passed separate versions of legislation that is necessary for implementing the spending and tax provisions of the balanced budget agreement. At present, differences between the two versions are being worked out together with the Administration. An area of major contention has been tax-cut provisions, but it appears likely that an agreement on these provisions will be reached shortly. In addition, the Senate version of the implementing legislation contained provisions to deal in part with the longer-term financing problems of Medicare by a phased increase in the age of eligibility from 65 to 67 and by basing premiums for Supplemental Medical Insurance on recipients' income levels. While the Administration has expressed agreement in principle with these measures, negotiations are continuing on their specifics.

The consumer price index rose 0.1 percent in June; the core consumer price index (the consumer price index excluding food and energy) also rose by 0.1 percent in June, and it increased at an annual rate of 2.4 percent during the first six months of 1997. The producer price index declined by 0.1 percent in June, the sixth consecutive monthly decline. The core PPI increased by 0.1 percent in June, but it declined at an annual rate of 0.3 percent during the first half of 1997. Despite an increase in employment of 217,000 in May, the unemployment rate rose from 4.8 percent in April to 5 percent as the participation rate continued to rise. Industrial production increased by 0.3 percent in June, about the same pace as in the previous three months, while the rate of capacity utilization remained unchanged.

Ms. Lissakers made the following statement:

On behalf of the United States, let me express appreciation to staff and management for this year's consultations. The staff papers were of the highest quality and the succinct—yet comprehensive and reader-friendly—coverage of cutting edge questions in the selected issues document merits replication.

The remarkable expansion of the U.S. economy continued over the past year at a brisk pace. It has now entered its 76th month, the third longest postwar recovery on record. The foundations for further sustained and balanced growth appear to be well in place.

Real growth rose 3.1 percent in 1996, gaining momentum over the year. After a robust first quarter (5.9 percent annual rate), growth is estimated by private analysts to reach 3-1/4 percent in 1997. Private investment, especially in computer technology, remains an engine of growth—real nonresidential investment has risen at an 8.3 percent annual rate since 1992 and real investment in information processing equipment is up over 100 percent during this period. Income inequality has been declining since 1993, with real mean incomes increasing more sharply in the lowest two quintiles of households than in the upper quintiles.

Inflation remains tame, especially given the maturity of the cycle and notwithstanding measurement bias in the consumer price index. The GDP chain price index rose 2.1 percent in 1996, the smallest increase since 1965. Through June of this year, the consumer price index rose at a 1.4 percent annual rate, the core consumer price index at a 2.4 percent annual rate, and the PPI has fallen every month.

Unemployment now stands at 5 percent. The United States added another 2–1/2 million jobs to its payrolls since the 1996 Article IV. Of the 13-1/4 million jobs created in the major countries since 1993, the United States accounts for 12-1/2 million. Two-thirds of the full-time jobs created in recent years have been in high-paying job categories.

The federal deficit continues to plummet. Last year, the deficit was 1.4 percent of GDP, the lowest in 22 years, and it is projected to fall this year to around 0.8 percent, and possibly much lower. In the first nine months of this fiscal year, the deficit was under $11 billion. A Bipartisan Balanced Budget Agreement was reached which establishes a framework for achieving a small surplus by FY 2002.

Despite this good news, growth at end-1996 and the beginning of this year was well beyond any measure of potential growth. Also, unemployment is now roughly ½ percentage point below standard estimates of NAIRU. In view of the persisting strength of demand, the Federal Reserve tightened conditions in March so as to raise the Fed Funds rate by 1/4 percentage point to around 5-1/2 percent.

Activity cooled significantly in the second quarter. Real retail sales declined an estimated 2.0 percent (s.a.a.r.) and housing starts fell 8 percent. Labor market activity has recently moderated. Fiscal policy and net exports are mildly restraining growth. This slowing, along with diminished inflation and inflationary expectations, is reflected in the decline in the 30-year Treasury bond yield to under 6-1/2 percent, down over ½ of 1 percent from the second quarter average. But as noted above, underlying conditions are favorable and consumer confidence, according to the Conference Board, is at the highest level since the first moonwalk. On balance, most analysts believe that growth over the remainder of the year will be in the range of potential, or slightly higher.

The Federal Reserve recognizes that resource utilization is in a range where price pressures could emerge, where vigilance is required, and where some tightening might be needed down the road to contain a potential rise in inflation, especially as monetary policy works with a significant lag. But the environment in which monetary policy operates must balance complex considerations.

First, though unemployment is most likely below NAIRU and there are uncertainties regarding the strength of prospective trends as well as NAIRU, there are also no price pressures on the horizon. Estimates suggest an unemployment rate 1 percentage point below NAIRU for one year should result in a ½ point acceleration in inflation. But they also suggest the decline in prices of nonpetroleum imports due to dollar appreciation has played a role in offsetting any impact on core inflation from the rates of unemployment below NAIRU experienced to date.

Second, labor costs are moderate. The employment cost index showed 3.3 percent wage growth in the twelve months through March. But the ECI continued to be held down by a modest 2.0 percent growth in nonwage benefits, reflecting decreases in costs for state unemployment insurance and workers' compensation and continued moderation in health insurance costs. The extent to which these shifts are transitory and nearing their end is not clear. Also, GDP-based productivity measures suggest unit labor costs are rising at a 2-1/2 percent rate at this time, in line with core inflation. Meanwhile, corporate profits are around 13 percent of corporate GDP, their highest level since the late 1970s, so scope exists to finance wage increases without affecting prices. Anecdotal reports suggest many firms do not have power to make price increases stick in view of globalization. Many of these issues are usefully highlighted in the second selected issues paper.

Third, there is the U.S. productivity puzzle. Productivity is growing 1 percent p.a. using GDP data, but 1-1/2 percent using gross domestic income. Detailed data suggest that productivity growth in 1/3 of the private sector, mainly in services, has been flat to negative for two decades. But service sector productivity is hard to measure—the output of a roomful of economists or lawyers is not easily decomposed into countable widgets. Holding productivity growth for such firms at zero boosts productivity by ½ percent p.a. Further, given heavy investment in computer equipment and strong growth in profits among service firms, even this assumption may be conservative. Or, as one of our Nobel laureates put it: "Computers are everywhere, except in the productivity statistics." On balance, if productivity has been higher over time than suggested by GDP data, this would have positive implications for historical assessments of real growth and incomes, unit labor costs and inflation. Further, this consideration is all the more salient if the measurement problem has been increasing as of late.

The staff's work on productivity in the background papers was most valuable, especially the comparison of total factor productivity in major countries. The points on the flexibility of our factor markets, including U.S. capital markets, as an explanation for higher TFP in the United States, were particularly intriguing.

Fourth, while monetary aggregates have become less reliable guides for monetary policy, there are some signs that M2 income velocity has been stabilizing. M2 growth has been running at close to the upper bound of its 1 to 5 percent target range. Finally, while stock prices are at high levels relative to traditional measures of equity performance, price increases in other asset markets are subdued. Historical studies indicate that an extra $1 of stock wealth only boosts spending by 3 cents, but the impetus to consumption from higher stock prices at this time appears to be smaller than would be suggested by historical relationships.

The Federal Reserve's legislative mandate specifies that the Fed's goals are maximum employment, stable prices and moderate long-term interest rates. This mandate has served the economy well. Also, the Fed does not have an official position on the establishment of formal inflation targets. However, the Fed's strong credibility goes without saying, the transparency of monetary policy has been substantially enhanced in recent years, and few market participants fail to understand how the Fed conducts policy.

The federal fiscal deficit, after reaching 4.7 percent of GDP in FY 1992, fell to 1.4 percent of GDP last year. In May, the budget deficit for FY 1997 was estimated to fall to $67 billion, or 0.8 percent of GDP. This year's Mid-Session Budget Review has been delayed. However, already the OMB Director has indicated that the deficit result will be "measurably" better than $67 billion and private forecasters foresee a fiscal year deficit on the order of 0.5 percent of GDP.

Underlying this strong performance has been surprisingly buoyant revenue for a second year. The reasons for this buoyancy are not well understood. Some analysts see it as transitory, resulting from the surge in equity markets. Others see it as more lasting, noting that recent revenue growth correlates better with growth in GDI, which has outstripped that of GDP, and points to strong receipts including from smaller services firms run by proprietors.

The U.S. government's determined efforts to strengthen fiscal discipline deserve much of the credit for the progress made toward deficit reduction and the economy's good performance of recent years. The Omnibus Budget Reconciliation Act of 1993 provided for $500 billion in deficit reduction over the following five years. The staff papers indicate that the 1993 Budget Act, with its important revenue measures, was a turning point.

At the time of the 1996 Article IV, we observed that the Administration was committed to achieving a balanced budget by FY 2002. This commitment found expression in May in the Bipartisan Balanced Budget Agreement (BBBA) reached between the Administration and Congress. This agreement is historic and credible because it embodies the "ownership" of the broad political community. Good progress is being made in specifying measures and implementing its terms. The BBBA retains budgetary measures that have existed this decade providing for caps on discretionary outlays and requiring changes in taxes or mandatory programs to be paid for (PAYGO discipline). The assumptions underlying the agreement are conservative. Indeed, Table 6 offers the Board the rare treat in which the Fund staff's fiscal projections are more optimistic than the authorities'.

But a few comments are warranted on staff's analysis. First, there is no realistic prospect that the pace of deficit reduction will be legislatively advanced within the framework of the BBBA. However, the Senate has already expressed its view that should revenues be stronger than projected, these windfalls would be reserved exclusively for tax cuts and/or deficit reduction. More generally, given the small level of the deficit, a faster pace of reduction would be of little macroeconomic significance.

Second, the discretionary cuts proposed under the BBBA are realistic and attainable. Military spending has already declined significantly, nearly 1-1/2 percent of GDP to the 3-1/2 percent range over the past five years, and it is expected to fall almost 1 percentage point further under the BBBA. Other discretionary spending is falling less rapidly in terms of GDP. However, nominal nondefense discretionary spending will rise slightly over the life of the BBBA, such spending will be higher than the majority party in Congress proposed, and the BBBA provides for several programs sought by the Administration. Third, the targeted tax incentives in the BBBA reflect longstanding priorities of the Administration, such as investment in higher education and tax credits for children, that are viewed as critical for enhancing U.S. efficiency and allowing our citizens to maintain high standards of living in a globalized economy.

Staff rightly focuses on Medicare and Social Security as facing financial challenges that are important for the long-term conduct of fiscal policy. The Administration is keenly aware of the importance of putting both on a sound long-run footing. Medicare is clearly of more immediate concern. Spending per Medicare recipient has doubled in the past two decades and the percentage of the population enrolled has increased. These trends are projected to continue leaving a major financing gap. The main Medicare trust fund had been projected to be depleted by FY 2001. But the BBBA provides for Medicare reforms aimed at achieving $115 billion in savings. This will extend the life of the trustfund by five years to FY 2007. The Administration has proposed that once the BBBA's provisions have been put in place, a bipartisan commission should be established to develop options for long-run reform.

The problems of Social Security are also significant, but must be kept in perspective. social security will not begin running a deficit on current policies until 2010 and its assets would only become exhausted around 2030. Further, a small combination of measures that could generate the equivalent of a 2 percentage point increase in the Social Security tax rate could secure long-term solvency. As noted in the Fund's Occasional paper on Aging Populations and Public Pension Schemes, the current net unfunded liability of social security and estimated contribution gaps are far below the G-7 average and because Social Security is a partly funded system it is less vulnerable to future demographic change than PAYG systems.

Much work has been completed in defining options for Social Security's future, and indeed, a Commission has laid out three such ideas. The Administration recognizes that tackling this problem sooner will substantially lessen the overall adjustment costs to the system. It is hoped that with the bipartisan momentum established under the BBBA, the executive and legislature will soon turn their attention to finding a lasting solution to the financing of Social Security.

The United States recognizes the dollar's important reserve currency role and our special responsibility to the international monetary system. Secretary Rubin has stated that a strong dollar is in America's economic interests. The G-7 have noted that exchange rates should reflect fundamentals and the importance of avoiding exchange rates that could lead to the reemergence of large external imbalances.

The long-term sustainability of the U.S. external position merits close scrutiny. It is important, however, to appreciate the range of factors now influencing the current account deficit, including the interactions between: our sound fundamentals; weak cyclical positions in other major industrial countries; and the unparalleled depth, liquidity and resilience of our capital markets which have attracted large capital inflows. U.S. export growth remains quite robust at this time and increasingly, fast-growing developing country markets are accounting for a larger portion of U.S. trade flows. In addition, the ongoing effort in the United States to promote fiscal balance will contribute to further marked strengthening of national savings, while investment may likely cool from its recent heady pace as the economy slows and the cycle matures.

The United States is deeply committed to an open international trading system. The expansion in world trade in recent years has been a major engine of job creation and growth in the United States, and international trade contributes to the competitiveness and dynamism of our economy. The Administration is strongly supportive of, and actively using, the new WTO dispute settlement procedures as a means of promoting and enforcing the rule of law in international trade relations. Furthermore, to underscore to our citizens the benefits of international trade, the United States is committed to pursuing opportunities for sectoral and regional trade liberalization within a multilateral context. It is hoped that such efforts will create synergies and spillover effects which will build momentum for further multilateral liberalization.

Mr. Bernes made the following statement:

I commend the staff for a well-written consultation report and a set of useful background documents. I particularly welcome the staff's attempt to focus on results and policy implications rather than methodology in the Selected Issues papers. I generally agree with the staff appraisal, and congratulate the U.S. authorities for their skillful management of their economy. My statement will focus on some general issues concerning prospective economic developments, and fiscal, monetary, and trade policies.

The U.S. economy has enjoyed a combination of strong growth and quiescent inflation in recent quarters. According to the staff outlook, growth will decelerate to a more sustainable pace in the latter part of this year and remain at just over 2 percent in 1998 and subsequent years. At the same time, consumer price index inflation is expected to rise to about 3 percent and stay at this rate over the medium term. This outlook is within the range of private sector forecasts. While there do not seem to be any major imbalances in the economy that could cause a major disruption to this soft-landing scenario, there are risks to the outlook.

It is unclear why the rate of inflation stabilizes in the staff's projection. According to the staff's estimate, the U.S. economy is currently in excess demand. A slowing in growth to the rate of potential will not eliminate the output gap and should not in principle lead to a fall in inflationary pressure. Does the staff assume that only changes in the output gap, and not its level, affect the inflation process?

The good inflation performance in recent quarters is partly attributable to temporary factors, such as a decline in oil prices, the appreciation of the U.S. dollar, and ample unused capacity abroad, all of which have reduced prices of imports and held down the pricing power of domestic producers. As well, employee compensation has been held down by a sharp decline in employers' health care costs attributable to the introduction of HMOs and other structures to contain rising medical expenditure. With this process largely completed, there might be little scope for further cost reductions. A reversal of these trends together with excess demand pressures could lead to higher inflation.

There is little cycle in any of the projected series. Real output growth quickly stabilizes at potential rate, and interest rates, as well as the rate of inflation, quickly rise to what seems to be their long-term equilibrium values. I would have thought that the fiscal restraint arising from the balanced budget plan might introduce more of a cycle into output growth and interest rates. Comments from the staff would be appreciated.

Adding to uncertainty about the U.S. economy are the problems in the measurement of output and prices, as indicated by the staff. In such an uncertain environment, it is imperative that economic policy errs on the side of prudence.

The recent budget agreement is a significant and welcome development. I would agree that the balanced budget agreement, if adhered to, would eliminate the deficit by 2002 *provided* the economy avoids a significant downturn. I also concur with the staff that the plan should be restructured to ensure more front-end loaded deficit reduction, bringing forward the timing of spending cuts and delaying tax cuts. With the U.S. economy at or above full employment, a front-loaded fiscal reduction plan would help contain inflationary pressures and allow for less tightening of monetary conditions. The resulting lower interest rates would yield a larger fiscal dividend than a back-loaded plan. A front-loaded plan would also increase the latitude for counter-cyclical fiscal policy in the event of an economic downturn. I share the staff's concern that the plan relies on substantial further cuts in discretionary spending that are concentrated after FY 1999. These cuts might prove difficult to implement should economic and political conditions turn out to be less favorable.

The budget resolution fails to include major structural policy changes to address underlying long-term fiscal problems. Specifically, it does not take substantive policy action on entitlement programs such as Medicare and Social Security where, in the absence of corrective measures, demographic factors will cause deficits and debt to GDP levels to rise to unsustainable levels.

It is important that the cyclical improvement in the fiscal situation, largely due to an unexpected surge in revenues, does not weaken the authorities' resolve to address the long-term fiscal challenges. From both a domestic perspective and because of international considerations, as the U.S. plays an important role in determining world real interest rates, it is important that the U.S. rein in its structural fiscal deficit as early as possible. As the experience of most industrial countries in recent years shows, the best time to do fiscal 'house cleaning' is when the economy is doing well.

Clearly, monetary policy in the U.S. has been successful so far in the current expansion to contain inflation and contribute to growth of output and income. However, as the expansion continues, the risk of an acceleration in costs and price increases become more pronounced, requiring a preemptive tightening of monetary conditions. The staff's report on the discussion with the authorities reveals a possible inconsistency between concerns voiced by representatives from the Federal Reserve over the inflationary risks that were present in the economy, and the Fed's decision not to tighten monetary conditions. The Federal Reserve representatives reiterated the importance of a preemptive approach to monetary policy. They suggested that price pressures could intensify in the near future if the level of resource utilization remained high. They also dismissed the view that a structural change in the economy had lowered the NAIRU. Furthermore, in his recent testimony to the Congress, Chairman Greenspan stated that. " we endeavor to prevent strains from developing in our economic system, which long experience tells us produce bottlenecks, shortages, and inefficiencies. These eventually create more inflation, which undermines economic expansion and limits the longer-term potential of the economy." Taking into account these concerns, one would wonder why the Fed has not raised interest rates in recent months. Given the lags involved, isn't there a risk that inflation will increase in the near future owing to insufficient action?

In our view, a prudent approach to monetary policy would dictate a further, moderate, but relatively prompt, tightening as insurance against the emergence of inflationary pressures, which have thus far been contained partly by temporary factors. Moreover, the risks to the economy of a modest tightening at this time would seem to be quite limited given the continued strong fundamentals supporting domestic demand, such as record high consumer confidence, tight labor markets, rising real wages, and soaring stock markets. As we have witnessed in the past, the potential cost of waiting too long—until inflation pressures build up—would be much higher. This expansion, which is the third longest in the post-war period, has a good chance of becoming the longest expansion provided that the policy mistakes of the past are avoided. And a policy mistake now would not only jeopardize prospects for a soft-landing scenario, but also tarnish the Fed's credibility.

Clearly the short-term policy actions need to be consistent with the medium-term objectives of monetary policy. Admittedly, the Fed has been remarkably successful in achieving robust growth with relatively low inflation in the 1990s without the formal adoption of explicit targets for inflation and a definition of price stability as its medium-term policy anchor. However, this does not necessarily imply that the Fed would have been less successful, had it adopted an explicit target for inflation and a numerical definition of price stability.

We do not share the U.S. monetary authorities' view that the use of explicit inflation targets ."..would not leave sufficient flexibility for monetary policy to deal with cyclical fluctuations in economic activity." Shocks that cause cyclical fluctuations would also cause inflation to deviate from its target, which would require a counter-cyclical change in monetary conditions. Moreover, having an explicit target and a numerical definition of price stability serves to anchor inflationary expectations and enhance the accountability of the monetary authorities.

We welcome the Administration's on-going support for trade liberalization and look forward to early consideration and approval of fast-track legislation. We support the staff in encouraging U.S. authorities to continue to place greater reliance on engagement and multilateral co-operation as their principal foreign policy tool, rather than unilateral actions. We would also encourage the United States to take steps to ensure that the president will have the authority to indefinitely suspend application of Helms-Burton Title IV sanctions pursuant to the April 1997 USA-EU Understanding.

Mr. Fremann, speaking on behalf of Mr. Autheman, made the following statement:

The performance of the U.S. economy over the recent years has been quite impressive. The authorities have skillfully oriented the policy mix and they themselves candidly acknowledged that it is increasingly difficult to explain the prolongation of the expansion without visible inflationary pressures. As I share the main policy recommendations of the report, I would like to concentrate on some aspects which in my view cover both the most intriguing features of the US economy and its main policy challenges.

The prolongation of a strong noninflationary growth runs counter to our knowledge of short-term dynamics. It is becoming a source of admiration and interrogation. Despite high demand and investment, and tight labor market, tensions on the productive capacity of the economy are limited. The productivity of capital, through technological changes, may have increased substantially beyond available measures. Measurement problems are also critical when it comes to assessing the contribution of services to the economy.

The idea of a new economic regime has led high-ranking officials to predict an even more durable expansion and to suggest that the growth potential of the US economy has been underestimated. If so, there could be significant policy implications.

Regarding monetary policy, a preventive increase in interest rates would be warranted on the grounds of past experience. But if growth can be sustained at the current pace without inflation, monetary policy needs to provide the economy with adequate liquidity. In this evolutionary context, I would refrain from suggesting to the monetary authorities, as staff is once more tempted to recommend, to adopt a formal inflation target framework. I think that what is more important, as stated by the report, is to adjust interest rates in a reasonably predictable manner, which has been skillfully done by the FED so far, and to weigh more on the side of caution. Therefore, I would prefer, in the manner of the Bourgeois Gentilhomme of Molière who had been "talking prose for years and had never known it," that the FED keep on behaving as an inflation-targeter without knowing it, instead of following, as did the Bourgeois Gentilhomme, the latest fashion.

Regarding fiscal policy, a higher potential growth could result in a significant improvement of the current projections of tax revenues. Therefore, I would have to correct my own initial analysis that the fiscal policy could have been even more ambitious and that, regrettably, most of the fiscal adjustment is back-loaded.

If the "structural scenario" is valid, the sharp rise in the price of financial assets might be reflecting the anticipation that the growth potential is higher than estimated, or that the Fed has succeeded in bringing inflation expectations down to low historic levels. The fear of a bubble should therefore be downplayed. But I would like to recall that while bubbles are building up, we have a natural tendency to emphasize the soundness of the foundations and to ignore them. As a general rule, asset prices bubbles are initially explained by structural changes.

Against this background, I am concerned by the intention of the authorities to stimulate further the bullish mood of financial markets by reducing the capital gains tax.

If again the structural explanations are correct, there would be some reason to reconsider the traditional view that, notwithstanding short-term fluctuations, there is a long-term downward trend in the value of the dollar. This goes beyond the point, rightly made by the staff, that a strong dollar is temporarily helpful for the US economy (abating inflationary pressures) and for Europe (sustaining the recovery in growth).

Finally, I reiterate my regrets regarding the decline in the U.S. official development assistance, and more specifically the continuous lack of financial support to the ESAF, in spite of commitments made more than three years ago. The praise of U.S. leadership in the staff appraisal appears, at best, surrealist. I note that Ms. Lissakers did not comment on this issue, but does flattery deserve a response?

Mr. Shields made the following statement:

I join staff in commending the US authorities for their impressive implementation of fiscal and monetary policy over recent years. This has underpinned an exceptionally long and well-balanced expansion. The lack of inflationary pressure is particularly noteworthy. Indeed, the absence of any serious policy dilemmas would—in any other case—merit "lapse of time" consideration by the Board.

Turning to the risks to the near-term outlook I agree with the staff's assessment that " the major policy issue is to safeguard against the emergence of inflationary pressures." The staff does not seem to be in the camp which thinks that the U.S. NAIRU has fallen. Rather, staff is inclined to put the recent better-than-expected inflation performance down to "special factors" which cannot necessarily be relied on to keep inflation low in the future. Bearing in mind the U.K.'s experiences in the 1980s, I can appreciate the need for being very cautious before concluding that structural changes have actually reduced the NAIRU; equally however recent evidence does not seem to support the hypothesis that the NAIRU is unchanged. I found the work on job insecurity very interesting. The staff appeared to have ruled out this factor as the explanation for a lower NAIRU. I look forward to rigorous testing of their other hypotheses that falling nonwage labor costs and the higher dollar led to lower inflation.

One up-side risk which the staff paper could emphasize more concerns consumer spending. The staff forecast is predicated on a fairly sharp slowdown in growth in the second half of this year. While it does appear that consumer spending growth slowed sharply through the second quarter, the conditions for the personal sector remain extremely favorable, with rapid income growth, buoyant wealth, a tight labor market and higher levels of consumer confidence. Under these conditions it is quite possible that personal sector spending could reaccelerate, as indeed some Wall Street forecasters expect. If this were to occur, the inflation risk would obviously be all the more significant. How seriously do staff view the possibility of consumer spending picking up again?

The paper provides a relatively benign assessment of the other major—and opposite—risk, which is of a sharp downward correction in the equity market. The background paper suggests that the recent boom may reflect a permanent shift to a new equilibrium where the equity risk premium is lower, partly resulting from lower transaction costs associated with the recent expansion in mutual funds. Another possibility, not mutually exclusive of this hypothesis, is that the stock market has reassessed the long-run growth potential of the economy. Nevertheless, the risk must surely remain that part of the recent strength—and the gains over the last six months in particular—reflect volatile short-term flows which could be vulnerable to a sudden shift in sentiment. I would be interested in staff's views on the implications of large stock market correction for the U.S. economy and for other financial markets. Would we still expect this to be fairly benign?

It would be useful to have staff's views on the supervisory implications of the growth in mutual funds. More generally, how appropriate is the supervisory system to the complex financial system in the United States?

On monetary policy, I see little point in second-guessing Alan Greenspan on the appropriate path for short-term interest rates. He has a formidable track record. Yet the staff and the markets have often come to differing conclusions about the right level for rates. So far the Chairman has tended to be right, but it is not clear why he has been correct. It is therefore worth repeating the question put forward by Stan Fischer. Is the good record of monetary policy the result of having the right institutional framework or is it dependent on the Chairman and members of FOMC having apparently superior judgment to both the markets and the Fund?

The fiscal achievements of recent years have indeed been impressive, and seem to have contributed to a rise in national savings. But the savings rate remains low relative to most other G-7 countries, and with an aging population it is clearly important to make further fiscal consolidation a priority. It is also worth emphasizing that the current point in the cycle—with demand pressures relatively strong—represents a favorable macroeconomic environment in which to make progress. On the composition of the potential "balanced budget" agreement, staff are right to recommend that spending cuts should be made earlier and that tax cuts should be treated cautiously. I wonder, however, if they are not rather complacent about prospects beyond 2002.

Finally, a familiar question for staff but one which may be worth revisiting. Why has macroeconomic performance in the US been so much better than in Europe? In particular, I would be interested in staff views of the relative importance of greater labor market flexibility, macroeconomic policies, the role of new technology (as Chairman Greenspan emphasized in his Humphrey Hawkins testimony), and different responses to favorable world inflationary conditions?

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

The U.S. economy has been performing exceptionally well in the last few years. Many macroeconomic indicators, including inflation, the unemployment rate, and the budget deficit, are at their most favorable levels in several decades. Even more important, there is good reason to believe this good performance will continue, because this time the growth of output and employment has not been accompanied by the growing imbalances that have marred many previous upswings.

In addition, we welcome the continued reversal of the decline in national savings and the small increases in both private and public savings during 1996. We also note that the economy's strong growth has contributed to some narrowing of the income gap by bringing a rapid increase in the real income of the lower income groups. However, we think that increasing support for training and education, rather than increasing the minimum wage, will make a more effective contribution to narrowing the income gap in a lasting manner.

U.S. companies have improved their performance and strengthened their competitiveness in the international markets. In the absence of imbalances and bottlenecks, the strong competitiveness of U.S. firms, continued restraint on the growth of total labor costs, and the briskly growing productivity of nonfinancial businesses have paved the way for the continuation of reasonably strong growth in the future.

This statement will address some policy issues on which the staff and the authorities do not wholly agree, and identify what we see as possible weak spots where the authorities should take a more ambitious approach.

Probably the most difficult and contentious issue facing the authorities for some time is the question of the most desirable stance for monetary policy. During last year's Article IV consultation we argued that the seriousness of the inflation risk depends on whether demand would continue to grow strongly during and after the second half of 1996. As it turned out, the growth of domestic demand slowed in the third and fourth quarters, only to regain its strength in 1997. But strong net exports in the last quarter of 1996 offset the slackening in domestic demand, enabling output to continue its brisk expansion. At the time of the last Article IV consultation, we would have expected that such behavior of demand and output would heighten wage and price pressures, requiring the Fed to boost interest rates by more than a quarter of a percent to counteract them. In the event, however, inflationary pressures remained subdued, and instead of rising, actual inflation continued to fall by all measures. In the end, the Fed only increased interest rates once, by a quarter of a percent.

More recent economic developments have not only been positive, but also puzzling. The extent of the departure from precedent exhibited by the recent behavior of growth, unemployment, and wages is illustrated by one of the background notes containing a discussion of job uncertainty and the Phillips curve. Using past Phillips curve estimates to make an out-of-sample forecast gives a prediction that the level of unemployment in 1995–96 should have caused inflation to rise to about 4 percent in 1996. Or, put another way, that the recent behavior of wages and inflation would be consistent with a natural rate of unemployment of about 3.75 percent, lower than the range of available estimates. There is no doubt that something in the U.S. economy is significantly changing the behavior of unemployment, wages, and prices. But without a reasonably solid theoretical understanding of these changes, and thus without the ability to tell whether they are transitory or permanent, it is very hard to make any judgment about the desirability of a monetary policy tightening. Unfortunately for the policymakers, so far there exist only a number of working hypotheses but no conclusive evidence about the changed behavior of the Phillips curve.

The staff report offers several tentative explanations of why inflation has remained low during long periods of low unemployment and high capacity utilization. But even though we cannot be sure which specific factors may have helped restrain wage and price inflation, we should note one important circumstance. Most of the potential factors identified by the staff have an important common feature: none can subdue wage and price growth indefinitely. If factors like greater job insecurity, growth of labor productivity, globalization and more intensive international competition, and appreciation of the dollar are indeed the main reasons for subdued inflation, this does not mean that the Phillips curve has shifted permanently in such a way that it is now possible to keep unemployment permanently low and capacity utilization permanently high, while at the same time enjoying—as is the case today—historically low inflation. If and when some of these factors—for example the appreciated level of the dollar—begin to weaken, it is possible that at a given level of resource utilization, inflation will begin to rise more rapidly. This could happen, for example, if the strong dollar that has been reducing the pricing leverage of U.S. firms in domestic markets should weaken. A weaker dollar would give firms more room to raise prices without worrying about losing domestic market share to foreign competition.

These are considerations to be borne in mind when making monetary policy decisions. At this moment, however, we do not see them as providing a strong argument for an immediate further monetary tightening. The crucial question is whether, given the present monetary stance and such other important considerations as the expected stance of fiscal policy, we can expect domestic demand and output growth to slow enough to align actual output growth more closely with its estimated potential. We think that this scenario could materialize, and that the present stance of monetary policy poses no significant threat to the long-term objective of keeping prices stable.

For one thing, as explained in Ms. Lissakers's statement, there are some indications that the torrid pace of economic growth during the first quarter of 1997 has moderated in the second quarter. Even more important, real U.S. interest rates, both short- and long-term, are presently quite high at over 3 percent. This indicates that U.S. monetary conditions are not as loose as the nominal rates suggest. After all, inflation is at its lowest level in thirty years or so. In addition, the present high level of household debt, welfare reforms and the continuing reduction of the budget deficit, are acting as a brake on the rapid growth of domestic demand. At the same time, we noted Chairman Greenspan's remark during last week's testimony that the current stance of policy will need to be changed at some point in the future, and that the Fed attaches great importance to the careful analysis of future risks to the economy as it makes its policy decisions. We find it reasonable to expect that as on previous occasions, more than one interest rate increase will be needed before monetary policy has fully run through its cycle of tightening.

As to the issue of formal inflation targets, we have some doubts that such a procedure would do much to improve the quality and transparency of the Fed's policy making. First, as we understand it, there is no unanimous view on what level of inflation should be targeted. Second, the difference between the present inflation rate and the range of rates that might eventually be chosen as formal targets does not seem large enough to affect the decisions of economic agents. More specifically, the Fed has a well-established track record and good credibility. In terms of the economic effect, there is not much to choose between its commitment to price stability and a commitment to pursue an inflation target of, say, one or two percent. As long as inflation stays low enough that economic agents can disregard it in making their decisions, monetary policy is delivering on its mandate to create favorable conditions for economic growth.

However, to keep the monetary policy stance as it is without risking an acceleration of demand and inflation, fiscal policy must remain firmly committed to the goal of balancing the budget by 2002. We applaud the impressive success achieved so far in reducing the federal government deficit. While high growth has made an important contribution to strengthening the public finances, the reduction of the structural deficit from 3.2 percent in 1994 to a projected 0.8 percent in 1997 shows the actual size of the adjustment. However, we share the staff's concern that the bulk of further adjustment will come from cuts in discretionary spending.

In the 1990s, the federal government deficit has been substantially reduced thanks to higher fiscal receipts and reductions in discretionary and particularly in nondefense spending. Unfortunately, mandatory spending continued to increase during this period, and we are concerned, as is the staff, that unless the mandatory programs are subjected to deeper reforms, the credibility of the balanced budget plan could suffer. Moreover, some front-loading of spending cuts and back-loading of tax cuts, to achieve a more even distribution over time of both unpopular and popular measures, could enhance the political feasibility of fully implementing the plan.

We recognize that measured by industrial country standards, admittedly not very high, the U.S. fiscal position is very strong. However, both the U.S. economy and the world economy would benefit from a some further increase in U.S. national savings and some reduction in the U.S. current account deficit, which has steadily increased from the beginning of the 1990s. Experience shows that reducing the fiscal deficit is the most reliable way to achieve this objective. Also, the persistence of a current account deficit averaging more than $100 billion annually over the last five years represents a significant demand for world savings. From the global point of view, there must be more efficient ways of using these savings in less developed countries where the rates of return on investment are higher than in the mature U.S. economy.

On balance, the performance of the U.S. economy has been impressive. Alongside the traditional diligence, entrepreneurship and innovation of the American people, a well-managed economic policy has made a major contribution to this outcome. We trust that the lessons of this success will be heeded on both sides of the Atlantic.

Mr. Mozhin and Mr. Palei submitted the following statement:

The performance of the U.S. economy is so impressive that it has led many economists to believe that the significant structural changes have permanently increased the level of the economy's capacity. In 1996, the real GDP grew by more than 3 percent. The observed growth rate is even higher for the beginning of this year. The fiscal situation continues to improve and the pace of improvement is often above government's forecasts. The unemployment rate is below most estimates of "natural rate." The Dow Jones Industrial has surpassed the 8,100 level, and many claim that this increase is a reflection of fundamentals, including strong earnings of American businesses. As of today, no obvious signs of inflationary pressure are visible. It is tempting to agree with the term "the new U.S. economy" coined by mass media.

The staff presented an interesting overview of the economy and pointed to several issues that are crucial for understanding current developments in the United States. Our comments are limited to the monetary and fiscal policy, and to the economic role of the government.

The Federal Reserve's monetary policy is in the center of the world's attention. It is symptomatic and, to a certain degree, ironic that the semiannual report to Congress, presented by Mr. Greenspan puts the main staff paper in a new perspective. The staff's paper claims that "the authorities rejected the notion recently suggested by some economists that monetary policy might be conducted so as to "probe" for the lower reaches of the natural rate of unemployment." This week, Chairman Greenspan and his colleagues seem to have changed their minds. Of course, this situation is peculiar, but it simply shows how dynamic the U.S. economy is.

We are in agreement with the staff that the authorities should stay alert and continue to practice their art of macroeconomic management. But this is probably as far as we can go in our advice. Firstly, most of the leading indicators do not yet point to the emergence of inflationary pressure. Slightly increasing labor costs can be financed by robust corporate earnings; the industry is operating at an estimated 83.5 percent of its capacity; the core consumer price index inflation has slowed and producer prices have been falling; productivity is increasing. Secondly, job insecurity, global competition, and an increase in an overall efficiency in the U.S. economy seem to be plausible explanation for subdued inflation. In the current phase of the global business cycle, nothing points to the threat of a rise in the prices of tradables. Increased value of the dollar further insulates the economy from the import of inflation. Thirdly, recent research soundly questions the quality of available data on output and inflation. It may well be the case that productivity has systematically been underestimated and the estimation bias has been growing. We agree with the staff that this complicates the judgment further.

At the same time, we share the concerns of the staff about the likely consequences of possible misjudgment of the risks of inflation in the U.S. A delayed and significant interest rate hike could become very disruptive for some developing countries. For example, Argentina and Mexico have recently gone through serious adjustment and are now better prepared to face an interest rate shock. Still, stable financial markets would be preferable for their continuing recovery.

The budget deficit has been under the scrutiny of American public for a long time. Today we witness a continuous improvement in the fiscal area. The deficit has decreased from 4.7 percent of GDP in 1992 to 1.4 in 1996 and is expected to be below 1 percent this year. It is noteworthy that most of the improvement is attributed to the decrease in deficit's structural component.

A further step toward fiscal prudence was made in May with the announcement of the balanced budget agreement. We broadly support the staff's recommendations on the timing of measures and on the distribution of the adjustment burden among different expenditure items. In particular, the staff's advice on desirable reallocation from defense to nondefense spending seems to be well placed. We also welcome the authorities' plans to reform the Medicare and Social Security system. The latter will certainly benefit from the improvements in the methodology for calculating the consumer price index and also from possible adjustments in the cost of living indices.

In a sense, the balanced budget agreement further develops the approach used in the Omnibus Budget Reconciliation Act of 1993. Back then, in addition to caps on discretionary spending, the PAYGO requirements had been introduced and the goals of fiscal prudence had been institutionalized. The balanced budget agreement is another attempt to create a norm that would neutralize what the public choice theorists call a natural proclivity of democratic politics to generate deficits. The implementation of the agreement will certainly provide an interesting information on the efficiency of such approach.

Finally, the United States seem to find a good balance in defining the economic role of the government. In recent years, American administration has been actively promoting deregulation of the domestic communications industry, as well as of the utilities' sector. Advances in this area provide know-how for other countries. Now the authorities concentrate on the U.S. financial sector and aim at modification or repeal of the Glass-Steagall restrictions. Deregulation not only fosters competition in the domestic market. It also prepares American businesses for global expansion. The wave of deregulation in domestic markets is combined with a forceful international promotion of trade openness, capital account liberalization, and protection of property rights. Domestic and international economic policies of the government are mutually beneficial. They enhance the future growth prospects for the economy.

In conclusion, we would like to follow the example of other directors, and refer to the world of motion pictures. Paraphrasing a movie so much liked by Americans, we say: "Run, America, run!"

Mr. Shaalan made the following statement:

As detailed in the well-focused staff report and Ms. Lissakers's comprehensive statement, developments in the United States economy for the past several years have exceeded all expectations. Last year, the economy continued its strong performance of sustained growth, subdued inflation, decreasing fiscal deficits—currently below one percent of GDP—and a drop in the unemployment rate to about five percent. The authorities should be commended for their skillful management of financial policies which have resulted in one of the longest growth cycles since the 1940s. Adding to the dynamics of the United States economy, is the well-known flexibility in the labor and product markets which has been instrumental in creating roughly 270,000 new jobs a month since the end of 1995 and pushing labor participation rate to an all time record high. While this favorable outlook is expected to continue, given the high resource utilization, the staff rightly identified the immediate challenge facing the authorities, namely that of maintaining steady growth in a mature phase of the cycle without igniting inflationary pressures. I will limit my remarks to addressing some of the key messages of the report on this aspect.

Regarding monetary policy, where the dominant issue during this year's consultation discussions has been, as indeed it was last year, concern about inflationary pressures emerging at this stage in the cycle. The absence of inflationary pressures (other than asset inflation) in a period where the rate of growth has been above the so-called potential growth rate and the rate of unemployment dropping below the lower end of the natural rate of unemployment is indeed puzzling. I say puzzling because in last year's consultations report, the projected growth of the economy was placed at 2.2 percent for 1997. One year later, this estimated growth as shown in the present report for the same year, is put at 3.8 percent. This raises the following question. Had last year policy makers and staff projected that the economy would be growing at the 3.8 percent rate, would monetary policy have been tightened then? My guess would be yes. Would it have been the right decision? I would appreciate any views the staff might have.

The core P.P.I. trend of recent months is negative. To the extent that this is an indicator of near-term future consumer price levels, it would appear that inflation will remain well below the notional target for the period immediately ahead. But we all know that monetary tightening begins to work with a lag of several months. Looking ahead, account must be taken of the many factors cited by staff and other observers, that have contributed to this high growth/low inflation environment. These factors will not be lasting or their contribution to reigning in inflation will diminish.

While the economy appears to be slowing down in the second quarter of this year from the torrid pace of the first quarter, the outlook for the balance of the year suggests that growth for the following year will be sustained in the vicinity of 2.5 percent, and possibly higher on account of robust consumption growth. The elements for the surge for consumer demand during the second quarter of the year are present. The higher level of growth of the recent past, the low unemployment rate, job security and low inflation are all factors conducive to robust demand. Another consideration that could well have an impact on the consumer demand is the bullish equity markets of the past 2–3 years which have been reaching record levels. This, in my view, will add an incremental but important dimension to consumer confidence and demand. There is a major difference between the asset inflation of the 1980s and that of the 1990s. Today, United States households have become increasingly important players in the equity markets—directly or indirectly.

Having said that we strongly subscribe to the view that the economy is now in a zone where monetary vigilance is required. Given the prudent approach to monetary policy by the Federal Reserve and its well earned credibility, we are confident that the FED will continue to follow a forward looking preemptive approach to monetary policy. This is important not only for the United States' economy, but also for the rest of the world. The monetary policy stance of early 1994 should be avoided.

On the fiscal front, remarkable strengthening of public finances has been achieved in the past several years—a deficit reduction from 4.7 percent of GDP in 1992 to 1.4 percent in 1996 is remarkable and appears to be continuing. Further fiscal improvements should result from the agreement reached recently between the Administration and Congress to balance the budget by FY 2002. The agreement includes tax and spending cuts, however, details on implementing the agreement's terms and specifying the measures will not be an easy task given the different views between Congress and the Administration on these issues. According to Table 5, much of the deficit reduction would be realized late in the budget horizon. We would concur with staff that in order to strengthen the plan's credibility and reduce demand pressure it would be desirable if a faster pace of deficit reduction can be achieved, by moving the timing of spending cuts forward and delaying the tax reductions. Note should also be taken of the difficulties in enacting legislation aimed at reforming mandatory outlays to effect savings as well as introducing savings cuts in discretionary spending. Finally, we are somewhat concerned that in this global mood of balanced budgets as a desirable goal we may be less attentive to key and necessary expenditures by the government. In this connection I very much share the concern of the staff reflected in their emphasis on the importance of maintaining adequate outlays for Public Service and infrastructure lest these become a bottleneck to further growth down the road. Also worrisome is the continued decline in foreign assistance. The U.S. should set an example, in this regard, to other donors.

Going beyond the immediate outlook, fiscal sustainability hinges on continued progress in the Medicare and Social Security systems. The reforms envisaged in the balanced budget agreement are expected to extend the life of the Medicare system for about ten years, however, fundamental reforms to the system over the long-term are needed. In this connection, we welcome the Administration's proposal to establish a commission to address the longer-term finances of the system. With respect to the Social Security system, where the financial problems are less pressing, early action to improve the system's longer-term financial position will reduce the need for more difficult measures in the future. Such an approach would have a positive impact on the budget and would contribute to a reduction of the public debt which is currently at about 50 percent of GDP.

We join the staff in commending the role the United States has played in promoting trade liberalization and widening its scope. We applaud the shift in U.S. policy in favor of resolution of disputes on a multilateral basis and we sincerely hope that reliance on unilateral trade measures will not be resorted to. The legitimacy and effectiveness of the rules-based multilateral trading system should not be undermined. Finally, on trade, the Fund has been strongly advising developing countries to accelerate trade liberalization in order to secure the benefits of free trade. For this to fully materialize it is important that the U.S. play a leading role in liberalizing trade in the agriculture and textiles sectors.

Finally, we commend the United States authorities once again on their successful economic management and wish them continued success.

Mr. Kannan, speaking on behalf of Mr. Sivaraman, made the following statement:

We welcome this opportunity to discuss the Article IV consultation report on United States. In terms of our usual phrase, in the case of United States, the cup is almost full and the issues are not many. The performance of the economy in the last one year is truly remarkable and we commend the authorities for their achievements. In this regard, the following are worth mentioning, viz. recent pick-up in the real GDP growth from 1.3 percent in 1995 to 3.1 percent in 1996 and further to 5.9 percent in the first quarter of 1997 and decline in the unemployment rate to 4.9 percent in April, 1997—the lowest rate since 1973. Despite high levels of resource utilization, we do not see any problem on the inflation front even though consumer and producer price inflation were slightly higher in 1996 reflecting the acceleration in food and energy prices. Fiscal policy actions and sustained economic growth have resulted in a steady decline in the unified federal budget deficit from 4.7 percent of GDP in FY 1992 to 1.4 percent of GDP in FY 1996. In this, it is important to note that even the structural deficit revealed a significant decline. The U.S. has undoubtedly set an example as to how a proper husbanding of the market mechanism and consistent inflation reduction could lead to dramatic results. We hope this will be sustained in the future. We fully share the staff recommendations.

The moot question is how to safeguard against the emergence of pressures and to prolong the life of current economic expansion. The euphoric rise in stock prices is a worrisome phenomenon. The staff exercise shows that this is against economic fundamentals. Any downswing here may have wide ranging repercussions world over. We hope the authorities are keeping a careful watch on this front.

The level of resource utilization is very high in United States. Given the detailed analysis on productivity, it is clear that further significant increase in productivity is very difficult to materialize in the immediate period. The authorities would remain vigilant and be prepared to tighten monetary conditions, if circumstances warranted, with a view to keeping inflation below 3 percent. In view of significant impact of US interest rates on other countries, not only developing but also other developed countries and other currency markets, preemptive and moderate moves in monetary policy would probably have less disruptive effects on these countries.

US dollar currency, held outside United States, amounts to a significant proportion of money supply. One argument is that this is the interest free credit to the U.S. The extent of currency held abroad now is not really known. We are aware of Federal Reserve Survey of 1984 and 1986 which indicate 80 percent of currency holdings could not be explained. I wonder whether the staff or Ms. Lissakers could throw light on this as well as impact of this phenomenon on U.S. monetary policy or inflation.

With reference to formal inflation targets, two remarks are worth noting viz., some members of FOMC had raised concerns that focusing monetary policy on the observance of rigid inflation targets would not leave sufficient flexibility for monetary policy to deal with cyclical fluctuations in economic activity. However, they also admit the setting of some elements on ad hoc basis. Staff may elaborate further on these points and also suggest ways to overcome these impediments.

On the fiscal side, we welcome the agreement to establish a broad framework for reaching a small fiscal surplus in FY 2002 and maintaining this through FY 2007. In this context in order to enhance credibility and to lessen the impact of adverse shocks, we share the staff suggestion that the time of spending cuts might be forwarded and tax cuts be delayed somewhat within the framework. In this context, two important areas are worth considering, viz., social security administration and Medicare. In the field of social security administration, the staff analysis is convincing and we share the view that the welfare gains from social security largely stem from protecting the very old. Hence, raising the age at which benefits can be collected may be an effective way to restore the financial balance while minimizing the welfare losses due to lower benefits.

Redressing Medicare's long term financial viability would require overhauling of the structural characteristics of the system in a way that would control cost and provide some incentive for beneficiaries to be more prudent users of Medicare services. Increases in deductibles and co-payments would provide such an incentive for beneficiaries and make them more prudent.

With reference to the exchange rate of dollar, the dollar appreciated by 4.4 percent in 1996 and by 7 percent in the first four months of 1997. Given the uncertainties for a successful launch of the Euro, we feel that this trend in dollar may continue for some more time in which case what is the implication of this for the current account balance in the immediate period and also for the interest rates in the United States. In the last few years, the dollar denominated external debt of developing countries has revealed a decline as compared with debt denominated in other currencies. Hence this development on the dollar front has some implications for the debt management of developing countries. Staff may like to shed more light on this aspect.

It is encouraging to note a small increase in the national savings, even though the draft of world savings by US is still high. However, given the degree of resource utilization and the need for productivity improvement, the need for further increase in investment is well recognized. Hence attempt should be made to continue this trend in augmenting savings in the economy.

In the field of trade policy, the contribution of the United States in strengthening multilateral framework of trade negotiation and its strong support for liberal and open trading regime is appreciated. However, we could not understand the views of the authorities that there was not sufficient momentum at present to move ahead on that basis alone and they place much emphasis on regional and sectoral efforts. We strongly encourage the authorities to refrain from unilateral policy actions that go against the rules of the multilateral trade system and intensify trade liberalization in traditionally sensitive sectors like textiles and agriculture, which are very important to many developing economies.

The World Development Report of 1997 has indicated that U.S. defense expenditure as a percentage of total expenditure stood at a high level compared to other industrial countries. Given the need for deficit reduction, it is important to pay attention to this area where there may be scope for economy. We welcome the authorities' clear indication to work with the Fund to ensure that arms purchases did not serve to undermine efforts to strengthen macroeconomic policies in developing and transition economy countries.

The United States has played an important leadership role in the area of Official Development Assistance (ODA). As a percentage of GNP, however, this has declined in recent years. We encourage the U.S. authorities to increase their ODA allocation. Furthermore, we also welcome high priority placed by the Administration on meeting its international obligations by paying arrears to international financial institutions.

We wish the authorities every success in their endeavors.

Mr. Andersen and Mr. Palmason submitted the following statement:

Had it not been for the systemic importance of the U.S. economy, it could have been argued that conclusion of this consultation on a lapse of time basis was justified, and so would a move to a 24-month cycle. Already well into the seventh consecutive year of expansion, the U.S. economy continues to surge ahead—beyond the most exuberant expectations. The Nirvana—like atmosphere of high growth, job creation, and subdued inflation has inspired confidence among investors and consumers alike. But whether this golden era of economic affluence is a one-time-event, taking the economy to a higher plateau, or an unusually high peak in a more conventional, albeit extended, business cycle, remains a mystery until more data has been gathered; either way, we join the staff in highly commending the authorities for their policy efforts and the outstanding performance of the economy. Looking ahead, however, there are challenges to be faced, most notably in the fiscal area, and particularly in connection with Medicare and Social Security, and perhaps also on the monetary side, but those challenges appear manageable.

Since the conclusion of the staff review, the dollar has appreciated considerably, and bond yields have fallen significantly. Although the speed of these developments has come as surprise, the magnitude and the direction of these movements do not seem to be out of line with fundamentals. Stock prices have also rallied to new heights, but developments in some traditional indicators for the stock market raises the question whether the price increase in the stock market is fully based on fundamentals. In any case, the most recent developments in financial markets validate staff views on growth and inflation, and we agree that the economic developments and the historically tight labor market warrant close monitoring to safeguard against any emergence of inflationary pressures. The sharp decline in interest rates in July, and the recent stock market surge, supports the view that private consumption should pick up again. With the other components of domestic demand looking strong, it seems plausible that growth rates in the second half of the year might be well above potential, although the surge in the dollar may contribute to a balancing of growth prospects.

One of the most remarkable achievements under the present upswing is that inflation is lower now than when the expansion began, which owes much to a generally excellent conducting of monetary policy. Inflation has remained stable regardless of capacity constraints in the economy, and there is a question whether a new understanding of inflationary propensity is called for or whether the developments are a product of possible one-off factors such as dollar appreciation, low raw material prices, an extraordinary growth in the labor force which for a short time may have raised potential noninflationary growth, or extraordinary job insecurity related to, inter alia, considerable high tech investment, as well as technical changes in the consumer price index. Moreover, globalization and increased competition may have reduced the scope for wage and price hikes. Comments would be appreciated.

The authorities deserve credit for their steadfast pursuit of reducing the federal fiscal deficit, and for taking important measures to reduce the structural deficit, thereby reducing an important imbalance in the U.S. economy. We welcome the recent agreement between the Administration and Congress to balance the budget by the year 2002, and to maintain the balance to 2007, and take note of the surprisingly strong development in the federal fiances in recent months which basically seems to reflect strong growth. However, we would be hesitant qualifying the BBBA strategy as ambitious or front-loaded against a background of seven good years of growth and possible future challenges. Moreover, it is of concern that a significant part of planned expenditure cuts are of discretionary nature and do not take effect until after 1999. The staff notes that some of this relates to key areas in services, such and maintenance of public infrastructure, which has already been compressed, while the authorities at the same time have intentions to raise spending in other priority areas such as education. To what extent net savings will take place is hard to judge at this stage. We do find it important that the planned structural improvements are carried through, thereby also reducing future problems should a recession emerge.

The financial commitments in Medicare and the Social Security systems somewhat constrain fiscal policy, and with the added burden of an aging population, these programs threaten to place increased burden on fiscal finances. The staff notes that a piecemeal approach to reform would suffice to put financing on a sustainable footing, albeit the situation is more difficult in the case of the Medicare program. Nonetheless, early action is warranted in both cases in order to allow sufficient lead-time for adjustment. Moreover, in the absence of reform, the longer-term vision of fiscal balance would be in jeopardy, as the assets in the HI trust fund might be depleted as early as 2001, and Social Security would start running deficits after 2010.

Monetary policy has been a flagship in the American policy arsenal; preemptive strikes against inflation have facilitated the pursuit of sustainable growth, and generally given due regard to the long lags that typically complicate monetary policy operations. We share the staff's view that the appropriateness of a further small tightening cannot be ruled out in the second half of 1997, particularly in light of some recent indications that the cooling-off in the second quarter of this year may have been temporary, and the Fed is well advised to stay on guard.

We see the current account deficit, albeit influenced by exchange rate developments, as a reflection of developments in domestic demand in the United States compared to its trading partners, as well as signaling structural imbalances in the U.S. economy. In that context, we share the staff's view that additional fiscal efforts would be an important contribution to raising the level of savings. This is especially important as the other components of domestic demand in the United States seem to develop in a very stable manner, reflecting the low savings rate in the private sector, especially among households. Furthermore, there is a risk that demographic factors could further reduce the already low level of private savings. We find it important that the United States take structural measures to increase the households' savings rate, especially directed toward the lower income groups.

We appreciate the historically constructive contribution the United States has made to form rules governing international trade. Hence, we can only regret when the United States invokes rules like the Helms-Burton Act. However, we find the policy shift in favor of using the WTO dispute-settlement process commendable. A continued and strengthened commitment to multilateralism would help strengthen global economic cooperation.

Despite the importance of balancing the budget, the affluence and leadership of the U.S. economy warrants a much higher level of ODA, as a share of GDP, more in line with other industrialized countries.

Ms. Lissakers noted that defense expenditures would bear much of the burden of future cuts in discretionary spending. As noted in the staff report, defense expenditures had been 4.9 percent of GDP in FY 1992 and were projected to decline to 2.7 percent of GDP in FY 2002, while nondefense expenditures were projected to decline from 3.8 percent of GDP in FY 1992 to 3 percent in FY 2002. Moreover, many expenditures on education, infrastructure and other public services were financed by state and local—and not federal—governments. Thus, cuts in discretionary spending would not affect social and public service expenditures as much as one might think. Also, many of the expenditures that were public expenditures in other countries, such as higher education, communications, and utilities, were partly or largely in the hands of the private sector in the United States.

On development assistance, the Administration was not pleased with the decline in official development assistance (ODA), and had tried very hard to persuade Congress to authorize the necessary appropriations, Ms. Lissakers continued. However, there was considerable public scepticism—partly justifiable—about the usefulness of ODA. The president had stressed on a number of occasions the high priority his Administration attached to clearing up U.S. arrears to international institutions such as the World Bank, the United Nations, including contributions to the ESAF. That commitment was reflected in the proposals submitted to Congress. Furthermore, the U.S. authorities' approach to bilateral assistance was changing, and more emphasis was being placed on technical assistance to improve governance, trade and investment liberalization, improved market access for developing country exports, and targeted assistance for investment in human capital. They hoped to work with other industrial countries in improving market access in industrial countries for developing country exports. The Administration's recent Africa Initiative embodied that shift in the United States' approach to development assistance.

Mr. Toribio made the following statement:

After reading the impressive staff report on the U.S. economy, one feels inclined to limit his intervention to two main points: congratulating the staff for their job and congratulating the U.S. authorities for the performance of the national economy. After those two expressions of satisfaction, the only sensible conclusion would be to wish that everything continues that way, both in the quality of the staff's work and in the behavior of the American economy whose very positive evolution will certainly exercise a favorable influence in many other countries.

Any additional comment has necessarily to be purely marginal but, nevertheless, let me try to make some side remarks with the only intention of contributing to promote some discussion in today's session of this Board.

To begin with, I will refer to the problems of measurement of U.S. output and prices, as they are explained by the staff. The questions related to alternative calculations of output—whether in terms of expenditure or in terms of income—seem to be limited to the U.S. institutional and statistical arrangements and I am not sure much could be learned from a deep discussion about their relative merits other than perhaps a better informed choice of one or the other parameter.

But the difficulties related to the measurement of the general price level are more serious because they refer to the nature of the parameter we use, not to their specific application in the U.S. case and, as such, they have a rather universal character. Not only the American consumer price index is a biased indicator of the cost of living but all Consumer Price Indexes we normally use tend probably to overestimate the inflationary behavior of the economies. In fact, the three biases pointed out in Box 1 of the report (quality, new goods, and commodity substitution bias) operate always and everywhere, and sometimes they probably lead us into wrong policy recommendations. That bias tends to be larger the higher the inflation rate, because changes in relative prices are presumably more intense in countries with strong inflationary pressures than in those with more stable general price levels, and its final consequences may not be trivial.

Coming back to the U.S. case, paragraph 7 of the staff report suggests a reduction on the indexation of social security benefits to "reflect the bias in the consumer price index." I fully agree with that suggestion but I also wonder whether we should not apply the same advice to many other economies and not only to the adjustment of pension payments. Many other economic decisions (about wages and salaries, rents, interest payments, etc.) are usually indexed to the consumer price index, which we have learned today is a wrong estimation of the inflation rate. If such is the case, many policy measures we recommend may be contributing to an exaggerated deflationary pressure when taken on the basis of existing consumer price index's. I would, therefore, suggest that the Fund staff remind us about this problem more frequently.

I would not like to take this point too far, but let me give another example which would be more relevant to today's discussion. According to the third paragraph of Box 1, the so-called Boskin Commission "estimated that the change in the consumer price index on average overstates the change in the cost of living by 1.1 percentage points per year, with a plausible range for the bias of roughly 3/4 to 1 ½ percentage points." I assume those figures refer to the U.S. economy, whose expected consumer price index increase in 1997 remains about 2 ½ percent. If we make the Boskin Commission's suggested adjustment, the American inflation rate would rather be closer to 1.4 percent or even as low as 1 percent.

Even before making that calculation I was not sure about the staff's preference for a moderate tightening of monetary conditions in the U.S. It seemed to me, first, that those monetary conditions were already being tightened by the relative appreciation of the U.S. dollar and, second, that monetary aggregates—whatever their relevance—were experiencing a decelerated, or even a negative, rate of growth. If we are now ready to recognize that the actual cost-of-living increase in the United States may be as low as 1 to 1.5 percent, I will have a further reason to doubt about the convenience of any new raise of interest rates in the near future. (That is certainly a decision on which there are as many reasons to advise its postponement as those that recommend its enacting now.) Perhaps the staff could react to that point of view.

I would also like to ask the staff's opinion about a possible miscalculation not only in output and prices (as explained in Box 1) but perhaps in balance of payments as well. The fact that the consolidated current account figures for the world as a whole do not register an expected zero balance but a considerable deficit makes one think that some important countries are underestimating their exports of goods and services, and the growing importance of invisible trade makes the United States a clear candidate to be counted among them. Is it not possible that the available figures are overestimating the U.S. current account deficit? If such is the case, we better recognize it. But if it is not, I would suggest we place the current account deficit of the United States ahead of the inflation rate in any reasonable ranking of concerns about the future of the American economy, at least until we are sure about the expansion of domestic demand in other important economies.

But, the most relevant event to prolong the current trend of balanced growth in the U.S. economy seems to be the agreement reached by Congress and the Administration to balance the federal budget by FY 2002. Here again reality seems to surpass the best dreams so that such a target could be easily advanced if the general government deficit falls below 1 percent of GDP in fiscal year 1998, a scenario which looks very probable at this time and which would imply only a very modest effort in the following years to achieve a zero-deficit position. If a robust economic growth continues expanding the tax base, the resulting increase in total government revenues may well allow an anticipation of that calendar. Such a will to tackle difficult fiscal problems could well be the second most important lesson we must derive from the American experience.

The first lesson would, of course, be derived from the capacity of the U.S. economy to generate employment across the whole spectrum of incomes and skills, a feature which many of us envy. That power to create jobs has allowed the United States during the last years, to continuously recycle imported unskilled labor, mainly from Central American countries who are, thus, contributing to fuel the United States expansion in a mutually profitable relationship. An interruption of the immigration policy, let alone its reversal, would not only mean a substantial cost for those Central American countries, but it could also affect the U.S. economy or, at least, certain parts of it, in a negative way. I would, therefore, hope that a satisfactory solution can be found to this problem, that may have important economic consequences. That was, after all, the essence of the American dream.

I wish the U.S. authorities my best.

Mr. Ono made the following statement:

At the last Article IV consultation discussion on the United States, many Executive Directors were concerned about the overheating of the economy. However, there are few signs of resurgence of inflationary pressures. It is quite impressive that the U.S. economy has high growth under low inflation, remaining noticeably healthy. At the outset, I congratulate the authorities for having achieved a remarkable economic performance, and note that the current expansion phase is one of the longest in the period since the 1940s. I would also like to commend the authorities for their strong policy credibility and their satisfactory macroeconomic policy. I will now make several comments on key policy issues.

As for monetary policy, the Fund should be highly commended for its skillful policy, particularly for its precautionary tightening in 1994, followed by a relaxed stance in 1995, and finally returning to a more cautious stance at the beginning of 1997. Given that the U.S. economy still faces up-side potential risks, I would like to ask the monetary authorities to remain vigilant in a preemptive manner concerning monetary policy.

Discussion regarding the topic of "inflation targeting" was held between the staff and the monetary authorities during the ongoing Article IV consultation discussion. In referring to this discussion in the staff paper, I sympathize with the watchful stance of some Federal Reserve Board representatives, and would point out that explicit inflation targeting has considerable problems in defining an appropriate measure of inflation to target. Since the above mentioned policy has enhanced its credibility, policy advice to recommend setting up a formal inflation target seems not to be as persuasive.

Another interesting policy discussion found in the staff report concerns the possible effects of increases in the U.S. interest rate on other countries, namely emerging market economies, as had been discussed in the last WEMD session. I again share the U.S. officials' view that a mild increase in U.S. interest rates in a preemptive manner would have a less negative impact on emerging market countries than a more drastic increase required later if tightening policy action were inappropriately delayed. This principle is also relevant to monetary policy in other industrial countries.

Regarding fiscal policy, the U.S. fiscal deficit has seen steady reduction, while fiscal deficit in terms of GDP ratio has substantially declined over the last four years from 4.7 percent in 1992 to 1.4 percent in 1996. That the United States has already reached the goal of the Maastricht criteria, leaving other industrial countries behind, is encouraging. On the other hand, I am afraid that Japan will likely be the last to achieve that goal.

In addition, recent balanced budget agreements between the Administration and Congress is most welcome. As the staff correctly points out, further efforts remain in specifying measures to achieve the target and in addressing long awaited reform plans, such as Medicare and Social Security. I think the most important way to promote decisive fiscal consolidation is a strong political will, since such measures are usually accompanied by pain and conflict among various interest groups. In this sense the value of the May agreement cannot be underestimated.

Furthermore, it should be noted that the benefit of progress in fiscal consolidation is not limited to promoting the vitality of the national economy and mitigating inequality among generations, but is extended to supporting economic activities through lowering the long-term interest rate, and minimizing the potential risk of international long-term interest rate hikes, as was evidenced during the Mexican crisis.

Regarding trade policy, recent extensive use of the multilateral scheme such as the WTO trade dispute settlement panels by the authorities is welcome. I also agree with the staff's view that the authorities should be cautious in the use of unilateral actions.

The United States now enjoys world performance success, but cannot overlook concerns about the macroeconomic policy. I will now touch upon this issue.

As far as short-term macroeconomic policy is concerned, careful attention should be paid to financial market development, particularly in the stock market.

In recent years U.S. equity prices rose markedly. Once, in spring 1997, equity prices fell by 10 percent, after which they immediately rebounded and reached renewed historical record levels each month.

Recent studies of the U.S. stock market have shown that the current level of equity prices can be explained by PER and "yield-spread" analysis. In other words, stock price movements are consistent with fundamentals, and then are not overshot. This analysis seems to have some merit. However, regarding future stock prices, one should be concerned about overly-optimistic expectations already existing, or existing in the near future, on the part of some investors. Another example, the recent trend of compression of risk premiums in junk-bond markets, also deserves attention. Mindful that the potential risks of downward revision of market expectation of future corporate profits, or future reducing interest differential between the United States and other industrial countries might trigger falling price levels in the U.S. equity and financial markets, might have not only a substantial negative effect on the U. S. economy, but on international financial markets and the global economy as well. Recent messages from Federal Reserve Board Chairman, Mr. Greenspan, and other U.S. officials to market participants indicate that the authorities are undoubtedly aware of this potential risk , and expect that the authorities will continue to carefully monitor movements in the financial market.

I will now briefly comment on three issues concerning further structural policy agenda. First, regarding the fiscal position, although the U.S. fiscal deficit in light of "flow base" has notably improved in recent years, public debt remains relatively high. The authorities should make every effort at debt-reduction. Second, after the U.S. became a net-external debt country, its external debt has continued to increase substantially. If this trend continues uncorrected, the risk increases of U.S. dollars losing credibility. Third, addressing the aging population problem is a major challenge to the United States. Given that the U.S. economy will confront an aging population in the next century, there is concern that the level of the national savings ratio, currently not high, will further decline in the future.

It goes without saying that the above-mentioned three items are interrelated. Clearly, improving the savings ratio is a major policy challenge to the United States. This seems to be the key to success for the United States in order to achieve sustainable and well-balanced economic growth in the medium and long term. In this connection, it is reassuring to see that the United States gross national savings ratio has increased over the last three years by 2.5 percent to about 17 percent in 1996. However, the current 17 percent of savings ratio is still far below the U.S. savings ratio during the 1960s and

1970s and the current savings ratio of other industrial countries. The staff has correctly pointed out in paragraph 67 of the report that "more substantial fiscal effort would raise savings and help to reduce both the current account deficit and U.S. international indebtedness. I support this view.

Finally, I would like to ask the staff to comment as to whether there is any specific policy recommendation, in addition to fiscal consolidation effort, to improve U.S. savings?

With these remarks, I hope the United States renews its longest economic expansion record of the industrial countries with an appropriate macroeconomic policy.

Mr. Esdar made the following statement:

Let me first commend staff for providing us with a well written and focused set of papers. Let me say from the outset that we agree with the thrust of staff's analysis and recommendation.

The U.S. economy has continued its impressive and outstanding performance for another year. The combination of the still robust growth performance with low inflation and the very dynamic creation of jobs have virtually diminished cyclical unemployment. We, therefore, fully agree with staff "that the authorities should be highly commended for their policy efforts" (p. 27, para. 60). We are also impressed by the continued progress in further reducing the fiscal deficit, the prudent and forward looking monetary policy of the Fed that has kept inflation in check, as well as structural flexibility that has enforced job creation and brought the unemployment rate to the lower end of the range of the natural rate. Indeed, the achievements in transforming growth and structural flexibility into the creation of new jobs provide an interesting lesson for those countries who are still confronted with unacceptably high levels of unemployment.

The chances to maintain this positive momentum are promising: A framework for reaching a balanced budget in a few years has been established, there is no doubt that the Fed will continue its credible and prudent monetary stance. By the way, I frankly cannot see how an inflation targeting could further strengthen Mr. Greenspan's broadly acknowledged reputation and credibility.

But back to the situation in the U.S. The flexibility of labor, product, and financial markets also provides a conducive framework to adjust to new challenges and to ensure an efficient allocation of resources in a competitive environment. Private consumption and investment are expected to remain the central engines for growth for the years ahead (p. 39, Table 3).

Let me now turn to monetary policy. Obviously inflation is still under control. Capacity utilization, unemployment, private consumption or other indicators do not yet signal the need for immediate action. However, I agree with staff that the Fed should be prepared to act immediately if overheating symptoms should appear also in light of the time lags inherent in monetary policy measures. Staff's warning about the "risks that price pressures could emerge in the period immediately ahead" (p. 12, para. 16) should be taken very seriously. Especially the boom in the stock markets indicates signs of overheating which should be observed very cautiously. However, the interest rate increase at the end of March has certainly helped to calm markets down and to mitigate potential inflationary expectations.

We were assured by the notion in the staff paper that "in general, FOMC members felt that inflation should be brought down further" and they aim to "moving over time to price stability" (p. 15, end/mid of para. 25). Somewhat in contrast, staff projects that in the years to 2002 consumer price index inflation will remain constant at 3.0 percent (p. 11, table), which according to the FOMC members, could still be regarded as "low inflation" and certainly not as "price stability."

With respect to reforms of U.S. financial markets, we have noticed with interest that the Glass-Steagall Act may be subject to modifications (p. 26, para. 58). This is certainly a welcome reaction to the globalization of the financial markets as it will help to level the playing field.

On fiscal policy: The unexpectedly strong growth early this year has generated additional tax receipts that have contributed to an even stronger reduction in the fiscal deficit than expected. However, these unexpected revenues should not distract the U.S. government and the U.S. Congress from implementing the medium-term balanced budget objectives. Already under existing plans, there is a certain tendency to go ahead with the politically favorable tax cuts and to postpone the unpopular task of cutting entitlements and expenditures to the later part of the planning period. Also, the recent improvements in the budget are to a large extent of a cyclical nature. The structural deficit is still around 1.6 percent.

Besides the direct consolidation objectives, there are also some structural weaknesses, especially on the revenue side, which should be addressed as well. Tax revenues are very much concentrated on direct taxes. The recent decisions to promote policy objectives like housing by referring to tax credits or tax exemptions could tend to erode the tax basis. That encourages us to come back to a proposal this chair made in earlier years, namely to consider to shift the revenue system more to indirect taxation. A value-added tax-system on the federal level might be one option, another one might be to increase energy taxes. However, I am aware that at least the last proposal will meet strong opposition.

Another side-effect of a shift away from direct taxing would be its positive effect on private savings which remain still relatively low in the U.S. in spite of some limited improvements in the past.

An increase in savings would at the same time be the most effective way to bring the current account closer to balance.

Demographic developments in the US—as in other industrial countries—indicate strains for the social security systems for the time ahead. A postponement of corrective measures will be increasingly expensive in economic and political terms. As in other countries, early and far reaching reforms of Medicare and Social Security systems in general are called for. We agree with the authorities that there is no quick fix and that reforms of the systems require a broad political consensus. However, we also agree with staff that "prompt efforts are required to reduce the financial burden that these programs otherwise impose." (p. 29, para. 69). Therefore, the bipartisan commission to design such reforms should be established as soon as possible.

I have to conclude with one topic which does not fit into the overall positive picture. The already extremely low level of ODA provided by the U.S. has declined further during the past year. In so far, we found the first sentence in paragraph 76 of the staff paper "The United States has played an important leadership role in the area of official development assistance" puzzling or "surrealistic" to use Mr. Autheman's terms. The United States rightly proclaim a leadership role also in development policies. The recent "Initiative for Africa" is a good example. But leadership not only means launching initiatives, but it also requires contributing in a balanced way. The financial support of ESAF, IDA and the African Development Bank for example, are crucial for economic progress in Africa. We strongly encourage our American friends to provide their appropriate financing share to these instruments and institutions, and we urge them to settle their arrears to international organizations. Insofar, I very much welcome Ms. Lissakers' reaction at the beginning of this meeting.

Mr. Levy made the following statement:

I would like to join previous speakers and commend the U.S. authorities on their policy efforts and the outstanding performance of the U.S. economy, as its expansion continues to be strong and broad-based. In view of the high level of capacity utilization and the low unemployment rate, I agree with staff that the Fed must remain vigilant and must not rule out tightening monetary conditions in the near future, although, I must admit, there is little evidence of pressure on prices as yet. On the contrary, consumer price inflation reached a 32-year low in the first half of 1997. Several factors have been put forward that could possibly contribute to the observed low wage and price increases, such as job insecurity, efficiency gains in the product markets, deregulation, an acceleration of business investment, low oil prices and the strength of the dollar. However, these factors cannot fully explain the continued absence of an increase of inflation, and as Chairman Greenspan explained in his recent testimony before Congress, many of them are limited or temporary and their effects are expected to diminish, at which time cost and price pressures would tend to reemerge.

Therefore, I agree with the U.S. authorities that monetary policy must not be conducted to probe for the lower reaches of the natural rate of unemployment. I also agree with staff that preemptive, moderate increases in US interests rates are to be preferred to a delayed substantial increase, given the lag with which monetary policy affects prices. I would emphasize that under the current circumstances, the policy risks seem to be one-sided, as it is unlikely that some moderate tightening of monetary conditions would seriously impact growth prospects, whereas failure to react promptly to early warning signals could end up with renewed inflationary expectations. The almost continuous and sharp rise of stock prices over the past two years is explained in Chapter VI of the selected issues paper by the increase in mutual fund inflows, which reflects the higher participation of households in the stock market in comparison with previous years. This development could increase the effect of stock prices on consumption, in comparison with the historical findings quoted by Ms. Lissakers in her statement, and would only make timely and moderate monetary policy action desirable, too. Resorting to moderate changes in monetary policy rather than waiting until more abrupt measures may be necessary will also be beneficial to the stock market by helping to avoid excessive and unnecessary volatility of stock prices.

I would also like to comment on the issue raised by Mr. Toribio regarding the bias of the consumer price index and its implications to monetary policy. In my view, as long as the bias is not corrected, financial markets will continue to react to the formally published consumer price index, and it would be a mistake to conduct monetary policy under the assumption that actual inflation is lower. The consumer price index is basically a benchmark and there is probably no single consumer whose consumption basket actually conforms with that of the consumer price index, and what matters more than the actual inflation rate is changes in the rate.

I welcome the recent budget agreement on a broad plan to balance the federal budget by FY 2002, with the intention to maintain a balanced budget until FY 2007. Although recent information indicates that the economy's strength may cause the federal deficit to disappear as early as in FY 1998, fiscal policy must remain sound and tight in order to leave the fiscal situation less vulnerable to adverse shocks and to be able to bear the costs of the ageing of the population in the longer term. The proposal to charge wealthier senior citizens higher Medicare premiums for supplementary medical insurance, is a step in the right direction but it should be supplemented by further steps to make the system more efficient, as suggested in the staff report. More generally on the budget plan, I agree with staff that its credibility should be strengthened by changing the timing of tax cuts and spending cuts. The underlying projections, such as continued economic growth of more than 2 percent until 2002, may turn out to be somewhat optimistic since they would imply an 11 year period of economic expansion. I was also disappointed to learn that the balanced budget agreement may further erode the simplification achieved by the Tax Reform Act of 1986 by adding more exemptions and incentives, such as deductions for educational expenses and a lower capital gains tax rate. Such modifications to the tax code are perhaps beneficial in the short run as they are pinpointed toward specific social and policy objectives, but over time as they accumulate they tend to make the tax system more cumbersome and less efficient.

I would finally like to comment on the issue of income distribution in the United States. One of the explanations for the success of the U.S. economy and its low unemployment rate in comparison with some of the European economies is the relative flexibility of its labor market. It has also been claimed that this flexibility occurred at the price of a much higher income inequality, as measured by several indices, than that in many of the European Union countries, including some that are plagued by rather high unemployment rates. However, data released by the U.S. Census Bureau reveals that in the years 1993–95 there occurred a slight improvement of the income distribution as measured by the Gini coefficient and, perhaps even more important, that the highest percentage rate of increase of income in those years occurred for the lowest income families. While it is probably too early to judge whether this phenomenon implies a break of the trend toward increased inequality which developed over the previous two decades, it may provide some evidence that could perhaps refute the hypothesis that higher growth associated with higher labor flexibility does not benefit the poor and that it results in higher income inequality. I would appreciate staff's comments on this issue.

Mr. Taylor made the following statement:

As Mr. Autheman said in his statement, the U.S. economy is a subject of admiration, but also interrogation. The near-term concerns, I suppose, are two. Obviously, the question about whether inflation may turn back is a very difficult one. All the risks do seem to be in one direction, as far as I can see. We have, firstly, a below-natural rate of unemployment, with participation at an all-time record high. Growth appears likely to remain above the long-run sustainable level. As Mr. Shields said, there might even be a case for anticipating stronger growth than the staff sees. The earnings figures are, of course, subdued, but in Chart 6 all the graphs point upwards. Recently, average hourly earnings have increased from 2 to 4 percent, with a further minimum wage increase coming later this year. The U.S. dollar has appreciated, and that must be due to cyclical i.e., reversable reasons. At least one price is out of control: the stock market. The remarks attributed to the Federal Reserve, included, on page 15, that at least some members felt inflation at present was probably at the upper end of the range that could be considered consistent with price stability. I believe that is correct. As Ms. Lissakers herself has emphasized, the chances of a less back-end-loaded fiscal adjustment are very small. So that arm of policy does not have much scope for response. All these risks are matters of judgment. As has been pointed out, the judgment of the authorities in this country has been extremely good. They have to be in the best position to make the judgment. But it is difficult to avoid the conclusion that almost all the risks are on one side.

The other area of concern must be fiscal policy. I have already acknowledged the difficulties of the budget process here. As Mr. Ono said, it is essential to have agreement amongst the community to get sustained improvement in the budget. Nevertheless, analytically, we still have to ask the question: is it enough? When the budget deal was announced, my recollection of the reaction of the financial press was one of sustained cynicism. Maybe that is a constitutional habit of the financial press. If you look at the figures in the tables on pages 39 and 42 in the staff paper, it does look as though this agreement is a promise not to reduce the deficit further over the life of this

Administration. So the question has to be raised, I think: in what circumstances should the U.S. budget ever be in surplus? I wonder what the view of the authorities is about that. As Mr. Bernes and others have said, the long-run deficit position of the U.S. government does not seem consistent with the long-run savings behavior of the economy.

Going back to income distribution. As Ms. Lissakers has pointed out, and as pointed out in paragraph 57, some interesting, if tentative, developments seem to be occurring there. This is a very important issue for some of us, I believe, because the widening income disparities, or fear of widening income disparities, in a lot of countries is a substantial impediment to introducing greater labor market flexibility. I would like to endorse Mr. Levy's request to the staff to do some further work on this subject or to pick up on the work that was done recently.

In that area, and also in some of the other technical issues concerning prices and productivity in growth, I would hope we would have the opportunity of referring to these technical issues later in the year. I guess that means much later in the year, given our agenda, but I think that these papers have raised a number of issues which we should try to keep track of and inform ourselves better. Perhaps some seminar toward the end of the year might be considered.

Mr. Yao made the following statement:

The performance of the US economy has been beyond expectation in recent years particularly in 1996 and during the first quarter of 1997. Therefore, I join previous speakers in commending the US authorities for the implementation of well-designed policies that have contributed to this impressive performance. Noteworthy have been the sustained economic expansion and the strong employment creation in a stable environment. These developments are particularly welcome, given the role of the United States in the world economy. I share however, the staff concern that there are potential risks, because of the high level of resource utilization. In this regard, I welcome the authorities' strong determination to pursue prudent macroeconomic policies during the years ahead.

Since I am in broad agreement with the staff appraisal, I would limit my remarks to a few points for emphasis.

Concerning price stability, I note from Ms. Lissakers' very helpful statement that the U.S. authorities have been successful in containing inflationary pressures in 1996 and the first quarter of 1997. While this has been largely the result of sound financial policies, I concur with the staff that other factors, such as the strengthening of the U.S. dollar, the decline in oil price and uncertainty in the labor market, have contributed to this favorable development. Could the staff explain to what extend these factors have contributed to this low inflation and whether the improved productivity could compensate the waning of these factors?

I welcome the emphasis placed by the U.S. authorities on price stability in the design of monetary policy. Also, as significant and large increases in U.S. interest rates have disruptive effects on the financial stability of developing countries that benefit from the globalized international market, I support preemptive and moderate moves in monetary policy. However, it is important to note that this approach bears some downside risks. I believe that, measures taken on the basis of anticipated developments that may not materialize, could constrain the economy to operate far below its potential, particularly because of difficulties in the measurement of output and prices.

On fiscal policy front, it is particularly noteworthy that the federal deficit, after reaching about 5 percent of GDP in FY 1992, fell to less than 2 percent of GDP last year, and is currently estimated that this deficit for 1997 will be much lower at 0.8 percent of GDP. I welcome the U.S. authorities' commitment to the deficit reduction that has helped in the implementation of a prudent monetary policy. The recent bipartisan balanced budget agreement reached in May of this year between the Administration and the Congress is testimony to this commitment. I would like to encourage the authorities to increase their efforts to implement this agreement and also to address at an early stage the problems of the social and Medicare systems.

On external policy, like previous speakers, I welcome the United States support for trade liberalization, particularly the authorities' intention to enhance exchanges with sub-Saharan African countries. It will be helpful if the staff or Ms. Lissakers could provide more information on that initiative. I would be interested on its scope and timing in its implementation. However, I am concerned with the decline in ODA recorded in recent years. This decline has brought US assistance to historically low levels, particularly in comparison with the stated goal of 0.7 percent of GNP recommended by the UN. I have noted in the staff report that in the authorities' view, ODA could be effectively spent, if it were targeted more to support developing countries' efforts in pursuing the implementation of strong macroeconomic and reform policies. Here I believe that the continuing contribution of the United States to the ESAF is consistent with their objective on ODA. However, I wonder whether it is also the authorities' view that an amount of ODA equivalent to 0.1 percent of GDP would provide enough support to the eligible developing countries.

In conclusion, I would like, once again, to congratulate the U.S. authorities for their successful macroeconomic management over the last five years. However, I join speakers who have stated that further work is needed to better understand today's strength and resilience of the U.S. economy. With these remarks, I wish the U.S. authorities further success in the management of their economy during the years ahead.

Mr. Al-Tuwaijri made the following statement:

The U.S. economy's impressive performance continues to exceed expectations. Despite robust growth and a decline in the unemployment rate in April to its lowest level in more than 20 years, there are few signs of inflationary pressures. Indeed, core PPI prices fell during the first half of the year. This success attests to the authorities' skillful economic management.

With such a record of policy and performance, it is hard to find something to take issue with. Indeed, the challenge now is to ensure that the exemplary performance of the economy is sustained.

In the fiscal area, the further improvement in the fiscal position is reassuring. I am also encouraged by the balanced budget agreement. The emphasis on reducing spending in order to provide some tax relief is appropriate. While I note some of the staff's reservations regarding the agreement, it is important to keep in mind the intricacies of this issue and the need to reach broad consensus. Thus, what is important at this stage is to iron out the few remaining differences on details.

Looking at the long term, I agree with staff on the importance of addressing the financial imbalances in Medicare and Social Security systems. At the same time, there is a need to build consensus for addressing these delicate issues. In this regard, measures included in the balanced budget agreement and the proposed establishment of a bipartisan commission to develop options for reforming Medicare are steps in the right direction. As for social security reform, I am encouraged by the authorities' cognizance that tackling this problem sooner will substantially lessen the overall adjustment costs.

I commend the FRB for its handling of monetary policy. As a result, inflation has been subdued despite buoyant economic growth and an unemployment rate below the bottom of its estimated natural range. I am confident that the FRB will continue to monitor indicators carefully and will take preemptive tightening measures as needed. Indeed, as the economy gained momentum earlier this year, the FRB increased the target rate for federal funds. For the time being, however, there does not seem to be compelling reasons to change the current stance of monetary policy.

Turning to the external sector, the recent strengthening of the dollar appears to be consistent with the relative strength of the U.S. economy. At the same time, such appreciation could aggravate the persistent and large current account deficits. In this regard, a strengthened fiscal position and efforts to increase private savings would help address this issue. It is also important for the United States to continue with its leadership role in promoting an open trading environment.

Finally, I join other Directors in urging the U.S. authorities to raise the level of ODA as a share of GDP as soon as possible.

With these remarks, I wish the U.S. authorities continued success.

Mr. Kaeser made the following statement:

Like previous speakers, I will begin by saying that the performance of the US economy in the recent past has been outstanding. The creation of more than 200,000 new jobs per month has pushed down the unemployment rate to a level not seen since the first oil shock—in spite of historically high participation rates. At the same time, inflationary pressures remained subdued. Despite a slight slow-down of economic growth in the second quarter, the outlook remains excellent. There are no signs of an end to the expansion, and many economists believe that the current growth performance of the US economy can be maintained until the end of the century.

Much of the American success story can be attributed to sound macroeconomic policy. In particular, monetary policy has helped to assure a stable environment conducive to growth. The Fed has followed an unorthodox approach by observing a broad range of indicators and setting monetary policy in an ad hoc manner. Its skill in anticipating and containing inflationary pressures has improved the Fed's credibility regarding its double objective of assuring price stability while safeguarding economic growth. We are confident that the Fed. will remain vigilant against the emergence of inflationary pressures, even without the definition of a formal inflation target.

Fiscal policy has also contributed to the favorable economic environment. Thanks to the continuing economic expansion and a political context which assures that budgetary consolidation remains a top priority of economic policy, the U.S. government deficit is now substantially lower than in most of the other advanced economies. With the bipartisan balanced budget agreement announced this spring, the budget is set on a sustainable track. The most important task is now to address the structural weaknesses of fiscal policy, namely to put Medicare and the Social Security system on a sounder financial basis. While the problems of these institutions are well known and the need for far-reaching measures is generally recognized, it will be hard to overcome the political obstacles to reform. There is also a question of sequencing of tax and expenditure measures. In this respect, the staff argues in favor of delaying tax cuts and bringing forward spending cuts. We agree with the staff that this would strengthen the fiscal position. On the other hand, for a country like the United States where the reduction of the deficit is no longer the main challenge for fiscal policy, a first move on the revenue side could be helpful for maintaining the pressure for further improvements of the public sector and a reduction in unproductive expenditures.

Sound financial policies alone do not explain the extraordinary combination of high output growth, low unemployment and the absence of inflationary pressures. Recent data and forecasts are completely out of line with what could be expected from traditional estimates of potential growth and natural unemployment rates. This outcome is puzzling and calls for an explanation which goes beyond the usual reference to favorable financial conditions and the role of the strong dollar in containing inflation. The Fed has put forward two possible explanations: Firstly, it has been suggested that increased job insecurity dampened wage pressures and inflation. However, a background paper by the staff finds no empirical relationship between different measures of job insecurity and inflation. Secondly, in his latest Humphrey-Hawkins report, chairman Greenspan speculates that the US economy could be experiencing an upward shift in its longer-range output potential. This hypothesis is based on the increasing share of services in output which aggravates the downward bias in estimates of productivity—thus suggesting that productivity growth (and thus potential growth) is indeed higher than measured. However, an increasing measurement bias also means that real output is actually growing faster. Thus, it cannot account for the unusual behavior of the output/inflation trade-off.

There are few explanations left for what is currently going on in the U.S. economy. The staff, in the background paper on Job Insecurity and the Phillips Curve, mentions the pricing behavior of firms but undertakes no formal analysis of this possibility.

There is also another issue which would have warranted further staff analysis. "Exuberance" of the stock markets has been cited as one of the reasons that motivated the Fed in March to raise the expected federal funds rate from 5.25 percent to 5.5 percent. However, the consequent fall in stock prices has already been more than reversed. This raises an important question: what are the risks associated with the booming stock market? According to the staff study, mutual funds were an important factor behind the increase in stock prices. Thus, a fall in stock prices could have a serious impact on household incomes. The planned reduction in the capital gains tax could further increase the risk of a bubble in the stock market. The staff comments on this question would be welcome.

To conclude, we would like to add a comment on a completely different issue. In the report, the staff repeatedly expresses its concerns about the international consequences of U.S. economic policy. While recognizing the role of the United States in the liberalization of world trade, we share the staff's concerns about the continuing use of unilateral trade measures. In this respect, we would also like to reiterate our reservations concerning the extra-territorial effects of the Helms-Burton Act. We note, however, that the U.S. is actively using the WTO dispute settlement procedure. Concerns have also been expressed about the very low and still declining ODA share. We agree with the US authorities that it is misleading to focus only on aid-to-GDP ratios. However, we are not convinced that U.S. development aid is more efficient than that of other countries. To this list of concerns about the international consequences of U.S. economic policy we can add the reluctance to participate in the financing of international initiatives. In our view, a well-performing domestic economy should facilitate the United States to assume the responsibilities associated with its status of the most important economic power.

We also concur with the message given by the staff on page. 75 when it urges the United States and other industrial countries to administer their policies on military sales to developing and transition economy countries in a way that avoids encouraging unproductive expenditures.

Mr. Grilli made the following statement:

As many Directors have underlined in their statements, the U.S. economy has indeed continued to grow under conditions of low inflation and sustainable current account deficit. The growth in output, given the rather restrained pace of measured factor productivity, has determined a strong demand for labor and generated a steady and strong expansion of employment. This has been, and continues to be, a remarkable performance, in absolute as well as in relative terms, compared to that of other major industrial countries.

U.S. growth has supported the world economy at a time when support was most needed. The United States has also shown remarkable ability to deal with medium-term structural problems and made strong progress in reducing its budget deficit, however measured, in modernizing and technologically upgrading its economy and in achieving a much higher degree of product and labor market flexibility than in most other industrial countries, thus laying down the conditions for continued growth in the medium term as well. These, too, are remarkable achievements driven by good policies and by steadiness in implementing them, as well as by credibility.

Naturally, there remain unsolved problems in the U.S. economy, such as rising disparities in the sharing of the benefits of growth, widespread uncertainties concerning job and income security, and the viability of the Medicare and social security system in the medium term. But it could appear almost as sophistry to focus too much attention on the problems that remain to be solved in the face of such a remarkable and credible performance and favorable results of the past seven years. I will not do that.

I believe, however, that there are areas where more attention is needed, not only because experience has shown that in the economic sphere, as in life at large, all good things have an unfortunate tendency to come to an end, but also because there are fairly clear risks in the short-term and medium-term economic picture that need to be kept under control to ensure continued good performance.

One risk, in my view, is that of a rekindling of inflation. For an economy that has been operating for quite a while very close or even above the estimated capacity limit. Even discounting the imprecisions of the estimates that we can make of potential output and NAIRU, it is clear that an economy cannot for too long operate at its upper limits of production without paying, sooner or later, the price of accelerating inflation. No-one can rely too much on good fortune, such as lower petroleum or commodity prices, or an appreciating currency to offset the price pressure emanating from aggregate demand being too close to the limit of productive capacity. Experience again has shown that variance of petroleum and commodity prices is in another direction and that an appreciating exchange rate can become a policy trap if relied upon too much or for too long to mitigate inflationary pressures. No-one also should rely on the hope that the NAIRU may be shifting down systematically.

The staff, in fact, rightly advocates some preemptive tightening of monetary policy during 1997, assuming that this will eventually work to moderate demand and also advocates some front-loading of fiscal adjustment for essentially the same purpose. The latter, however, will most likely not happen, as Ms. Lissakers's statement indicates, leaving the chief burden of controlling inflation and expectations on monetary policy. Many have remarked that the Federal Reserve has managed extremely well so far—obviously, one has to agree with that—and can be expected fully to continue to do so in the future, but in the recent past one has to recognize that the work of the Federal Reserve was perhaps helped in some respects by policy and performance in other industrial countries; for example, the price lag that existed. This may change with the coming recovery in Japan and hopefully in Europe. Commodity prices can also increase much faster than in the past. An interest rate adjustment in the United States may have to be done under less serene and favorable circumstances than in the recent past. Rising inflation could disrupt the expansion of the United States economy. My reading is that all, or at least most, of the previous cycles in the U.S. economy, at least in the postwar period, turned downward after an increase in inflation.

Keeping the economy going will thus constitute a challenge, as it is a challenge everywhere. Much like the Federal Reserve's staff and managers, as reported in the paper, I believe that structural changes have not made the cycle obsolete in the U.S. economy. I do not think that the cycle is dead. I personally have witnessed a previous declaration of death in the late 1960s, which turned out to be rather tragically wrong, and have acquired a certain immunity to claims in this area. Nor do I believe it is justifiable to think that changes in the operation of modern economies have dampened business cycles in general or made them less frequent than in the past. There is no credible evidence of it, despite a lot of theorizing or speculating about it. No-one can make yet a defensible argument that exogenous shocks are diminishing in significance or that cyclical dynamics have become more restrained. Hypotheses abound; evidence is still scarce. The staff's medium-term projection notwithstanding, which in a way can be interpreted as implying that the U.S. economy has now reached absolute stability in output, inflation, unemployment, and current account deficit, frozen at the 1997 level, the cycle will tend to turn downwards, in my view, if goods and asset prices are not kept under control. If this does not happen, experience shows, consumption and investments will be negatively affected and aggregate demand will slump. In the presence of such a tendency, either output or prices must adjust. Generally, we have seen production cuts as main parts of the adjustment process, and nothing suggests that this would not be needed in present circumstances.

Apart from a rekindling of inflation, coming either from excess demand or from an exogenous shock not fully compensated by monetary restraint, a substantial risk to the continuation of the current phase of expansion lies, in my opinion, in the overpricing of equities. I found the analysis presented by the staff in the background paper supportive of the concern of stock market price overshooting. I am more blunt in my language than the staff, which more elegantly referred to it as "irrational exuberance."

Dividend price ratios are at an historical low, and portfolio shifts must be considered not only possible but probably likely in conceivable circumstances. One wonders what could be the response of investors to an unanticipated change in bond yields, for example. I believe that this risk is underplayed in the staff policy analysis. One understands the reasons at one level, but at another it is puzzling that the results of the staff's own analysis on the behavior of stock prices are not more fully and explicitly incorporated in the policy discussion offered in the main paper. Could the staff elaborate on the likelihood, as it sees it, of an asset price shock, its possible effects, and, above all, the ways to deal with it, because there are obviously ways to deal with it.

Another risk that I found underplayed in the staff analysis, perhaps, is that of the appreciation of the U.S. dollar vis-à-vis the yen and most European currencies. This trend is, of course, beneficial in the short term to the economies of the European countries and Japan, since it supports their exports and stimulates them at a time when stimulus is needed. This cannot be denied and considered a problem in the current phase of the world economic cycle, but the medium-term risks of too large a disequilibria in exchange rates, particularly if measured on the basis of real exchange rates, cannot be underemphasized either. There are not only familiar unwinding problems, given the lock on policies that deviating exchange rates can cause, but also the effects of overappreciation on trade policies and the incentives that they give to bilateral responses and to the use of nontariff barriers. Could the staff evaluate these risks now or at an appropriate time?

Perhaps I have raised more questions than I meant to, and perhaps also than I should, in the face of such a favorable performance of the U.S. economy and of its unquestionable and enviable strength, but I have done so because, after reading the staff documents and meditating on official policy pronouncements, I came out with the sense that perhaps we were becoming a bit too complacent in evaluating the risks that are present in the situation. Needless to say, I have tried to ring the bell only to get the firemen ready should there be need of such a use of water hoses. I most sincerely hope not, not only for the sake of the United States but for all of us. The U.S. economic expansion has been and continues to be a public good for the world. That is why it ought to be preserved.

The Deputy Director of the Western Hemisphere Department made the following statement:

A key question involves the assessment of the extent to which recent performance reflects mainly temporary factors or something more fundamental. Mr. Yao asked, more specifically, whether the staff had an estimate of the extent to which special factors were contributing to the very good inflation performance, given tightness in labor markets. There are obviously both elements at play here, temporary and fundamental factors. Chairman Greenspan has said that it likely will be several years until we fully know what is happening in the economy. I could hazard a guess, using a rather mechanical calculation. The core rate of inflation currently is around 2½ percent, and under normal circumstances, one would expect that it should be around

4 percent. Recent developments with respect to import prices and benefit costs, which likely are temporary factors, explain about half of the difference between the expected rate of inflation and the actual rate. As we think about what is the possibility that something fundamental has changed in the U.S. economy, it is useful to recall what Mr. Autheman said: when "bubbles" are building, there is a natural tendency to assume that the foundations are very sound. Obviously, it is only after the fact that we see that that was a mistake. It is also useful to recall that it is not that many years ago when observers were very pessimistic about the U.S. economy. There was a feeling that U.S. managers had run out of ideas and that U.S. workers seemed not to be particularly interested in working, and people were looking to other cultures for answers to these questions. The current strength of U.S. economic performance may just be a reflection of how far the U.S. economy has come in the past few years, but it also may be a useful reminder that we should be very careful before we assume that there have been major changes in the economy.

Mr. Shields asked a related question, namely, why has performance in the United States been so much better than in Europe. As we were discussing today, macroeconomic policy in the United States has been very strong. To the extent that something truly fundamental has happened, I would say that one must attribute a large part of this to the flexibility of U.S. labor markets. In addition, as pointed out in one of the background papers, the very heavy investment in the United States in plant and equipment, and in particular in computer technology and other information technology, has also played a role. But without the ability to manage the labor force and work processes flexibly, those investments in and of themselves would have had a less substantial impact.

On a related issue, Mr. Levy and Mr. Taylor have asked the staff to comment on the implications of recent strong economic performance for income distribution. This is a very complex area, especially when we focus, as I believe is appropriate, on the equality, or lack thereof, of opportunity as opposed to ex post results. But one can say that, clearly, the strong economic performance, and the fact that more and more people are being drawn into the labor force and into jobs, has clearly been an important factor in the past couple of years. In our discussions with the U.S. authorities, they noted the strong support in the Congress for policies that promote strong growth performance with low inflation. Clearly, this setting creates the basis for undertaking other economic measures that would not be possible without that underlying strong performance. It is also clear, in looking at the situation in the United States, that one of the factors behind income inequality is inequality in skill levels of workers. Therefore, it is very important, when one looks at equality of opportunity, that those skill levels are equalized, and this points to the importance of improving education.

On monetary policy, Mr. Sivaraman asked how was it possible to reduce discretion in policy making while maintaining some flexibility. This, of course, is a difficult task. The announcement of an inflation target would reduce the discretion of the authorities with respect to that variable, but the target in and of itself does not provide any guidance as to the day-to-day management of policies that are aimed at achieving that target a year or two in the future. If the central bank wants to go further down that path, it can develop a single model of how the economy works, and publish that model, and then the market will know at all times exactly how the central bank is operating. But I wonder if many central banks would want to manage policy in that way. There may be many cases where it is useful to maintain some element of a lack of transparency. In the end, monetary management may be more of an art than a science.

Looking backward in the area of monetary policy, Mr. Shaalan asked an interesting question: If the Federal Reserve had known a year ago what it knows today with respect to where the real economy is, would it have raised interest rates? I strongly suspect it would have. The discussion a year ago related to this question: would the economy slow on its own or was there a need to take monetary policy action to slow it? In the end, no action was taken, but the economy proved to be very strong. And we have the extremely interesting results on inflation that we have been discussing today. Mr. Shaalan also asked: would it have been a good idea if the Federal Reserve had raised interest rates a year ago? I think we will know the answer to that question much better a year from now. The staff's feeling is that a slightly higher level of interest rates now would have taken some of the effervescence out of the markets and would have positioned the U.S. economy in a somewhat less risky position than it is now.

Looking ahead, Mr. Bernes asked a rhetorical question about the risk of a pick-up in inflation, and Mr. Shields asked: how seriously does the staff take the possibility of a pick-up in consumer spending? I would say here that the staff views the possibility of a pick-up in spending as being quite serious. In a way, what happens to demand in the period ahead depends very much on whether people really begin to believe that what is happening in the U.S. economy today is permanent or not. At the present time, we have the lowest level of unemployment in several decades and the highest participation rate on record. But at least some evidence would suggest that workers are reluctant to press wage demands, because of uncertainty about their jobs. Clearly, workers are not taking this very strong employment situation fully into account and are not spending sharply higher amounts on housing, and the housing market remains quite constrained, which reflects perhaps uncertainty about just how long the current situation will last. When one looks at confidence surveys, the degree of consumer confidence about the current situation is very positive. The degree of confidence about future prospects is also high, but not as high as the assessment of the current situation. We also have the quite strong evidence that, at least up until now, the very high level of stock market prices has not been reflected in consumer spending. Of course, if all of these uncertainties disappear, and people begin to believe that the strength of the labor market and the very sharp increases in wealth that have occurred in the past year or so represent something permanent, there could be major implications for spending as well as for the conduct of monetary and fiscal policy. It will be very important in the period ahead for the Federal Reserve to monitor labor markets and the housing market very carefully. I agree with Ms. Lissakers that there is some scope, given the very high profit margins, for some increase in wages to take place without major dislocations in the economy, but the situation will have to be monitored very carefully.

On the question of the implications of a downturn in stock market prices for consumption and the level of economic activity, there is no evidence as yet that the high level of stock prices has been built into consumption. However, as we go forward, if there were to be an increase in consumption spending based on that, clearly the disinflation of a bubble, if it were ever to occur, would be quite serious.

Mr. Toribio asked whether our advice on the conduct of monetary policy should not take into account the bias in the consumer price index. Clearly, the level of the bias is extremely important in the setting of the target itself. In advising on whether policy should be tightened or loosened or kept unchanged, I think what one is looking for is the extent to which one believes that inflation is going to accelerate or slow down.

I would like to clarify one point. Mr. Mozhin and Mr. Palei in their statement suggested that they read Chairman Greenspan's recent Humphrey Hawkins testimony as implying that the Federal Reserve has changed its mind relative to the discussion that is in the staff report about the appropriateness of "probing" for the lower reaches of the natural rate of unemployment. In fact, Mr. Greenspan in his testimony said explicitly that the Federal Reserve is not involved in an experiment that deliberately "prodes" the economy to see how far and fast it can grow. So I think the balance of considerations that is reflected in the staff report remains broadly appropriate.

A number of Directors have raised the issue that the Administration and the Congress should take advantage of the current strong situation of the economy to deal decisively with the fiscal situation. Here I would just note that the budget agreement itself is not per se an agreement to balance the budget. It is an agreement on a certain set of measures that would balance the budget, given the baseline that was estimated in the spring. To the extent that the underlying situation now is better—and many private analysts looking at the developments in revenue so far this fiscal year are suggesting that, indeed, the situation is much better—and provided that the Congress and the Administration take the budget agreement and put it on top of that much stronger underlying situation, the fiscal situation will improve much more substantially than implied by the bottom line of the budget that was in the agreement. It will be very important, as the agreement is implemented, that the Administration and the Congress not use any windfall in revenue to substitute for the measures that are in that agreement.

Mr. Shields asked whether the staff was too complacent about the budget outlook after the year 2002. I believe that, in terms of the budget agreement itself, we are not. The budget agreement includes certain safeguards. In particular, there is a limit on the extent of revenue reductions that will be agreed, and that should help preserve fiscal balance over the medium term. Of course, in addition to that aspect of fiscal policy, there are the important concerns about Medicare and the Social Security System, but the staff discussed those at some length in the paper.

There was some discussion this morning about the external current account for the United States, and Mr. Sivaraman asked specifically what the implications of continued strengthening of the dollar, in particular in the context of the introduction of the euro, would be for the U.S. current account and for U.S. interest rates. Of course, the strengthening of the U.S. dollar would tend to dampen demand for U.S. products. It would also continue to hold down price increases in the United States, and that would be a continuation of the situation we have seen over the past couple of years. That, however, goes counter to what we see as the long-run considerations for the U.S. economy, which is that at some point the current account deficit is going to have to start declining. So, the sort of short-run and longer-run implications of what is happening now in foreign exchange markets are somewhat different.

Mr. Toribio observed that, as that the official inflation rate was overstated by 1.1 percentage points—per the report of the Boskin Commission—the actual inflation rate was probably about 1 percent. While he agreed that the variation in the inflation rate was more important than the inflation rate per se, in view of the low inflation rate in the U.S. economy, he considered that an increase from, say, 1 percent to 1.5 or 1.75 percent was not a matter of concern. Moreover, it was possible that the U.S. economy was performing better than one assumed, given that there could be measurement errors in the statistics. Financial markets had probably factored in those measurement errors, and the strength of the stock market might be a reflection of markets' perception that the economy was performing rather well. Similarly, the strength of the dollar might be due to the fact that the current account deficit was not as large as the numbers would suggest. In light of the possibility that the economy might be performing better than one assumed, he considered that the authorities should refrain from pursuing activist fiscal or monetary policies.

The Deputy Director of the Western Hemisphere Department agreed that, if there were indeed underlying changes in the economy, those changes were probably not being reflected in the official statistics. The performance of the U.S. economy did not appear to be exceptional when one looked at official statistics on productivity growth and output growth. However, the existence of low inflation, together with a tight labor market and high profit margins, was indeed a puzzle. The answer to that puzzle was that perhaps productivity was much higher than the official statistics suggested, which would explain why the economy was able to operate at a high level of capacity utilization without price pressures emerging. At the same time, to the extent that one wished to assess whether there was any excess demand in the economy, a change in the inflation rate was a relevant factor. If the inflation rate were to increase from say, 2 to 3 percent, that is, the actual inflation rate were to increase from 1 to 2 percent after taking out the bias, that in itself was an important signal to the authorities that there might be excess demand pressures, which would call for adapting monetary policy. That did not mean that the bias in the inflation rate would not influence the authorities' choice of the monetary target; given the 1.1 percentage upward bias in the measurement, the authorities would probably not wish to target price stability because that would imply a deflation of 1 percent a year.

Mr. Levy remarked that, despite the measurement bias, the consumer price index (consumer price index) was important. After all, the cost of living adjustments were linked to the consumer price index and the Treasury had begun to issue bonds that were linked to the consumer price index. Furthermore, financial markets took into account the consumer price index in assessing inflationary expectations, and real interest rates were based on the consumer price index.

The staff representative from the Western Hemisphere Department made the following statement:

> As Mr. Toribio pointed out, there probably is a margin for measurement error in the U.S. current account deficit. It is particularly difficult on the services side to pick up all of the transactions. However, historically the largest errors in the U.S. balance of payments have tended to be more in the capital account side. In fact, in 1996, there was a negative statistical discrepancy of $47 billion, which, if anything, with regard to the current account, would suggest that perhaps the current account deficit would be somewhat larger. The statistical discrepancey does not quite go in the direction, at least in 1995 and 1996, that was suggested.
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> Mr. Bernes raised a couple of questions with regard to the staff's projections. We would emphasize that our assessment at this point is that the economy is basically at full employment. Given the lack of precision in estimating the rate of growth of potential output, and even more so in trying to pin down the actual level of potential output, we would hesitate to argue that the economy is in an excess demand position, particularly given the lack of signs of bottlenecks in the economy and inflationary pressures. What we have done in the forecast of economic growth is to proceed essentially with the current policy assumptions. With respect to fiscal policy, this means that the balanced budget agreement will be put in place and enacted as envisaged. In the context of monetary policy, what we are assuming is that—based on statements by some of the members of the FOMC who are reluctant to see core consumer price index inflation go above 3 percent—that any necessary policy actions will be taken to raise interest rates to bring the rate of growth of the economy back down toward potential. With respect to the speed of closing the gap between potential and actual output versus the level of the gap itself, the speed at which the gap is closed has implications for policy. If you are closing the gap much too rapidly, given the lags in monetary as well as fiscal policy actions, certainly that would be a concern. At the same time, the overall level of the gap is a major consideration in the formulation of policy.
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> Also, Mr. Bernes raised the question with regard to the absence of any cyclical movement in the staff's projections, in particular with reference to the withdrawal of fiscal stimulus coming from the balanced budget agreement. The actual withdrawal of stimulus associated with the balanced budget agreement is probably about 0.75–1 percent of GDP over a 3 to 5 year period, depending upon how the fiscal balance evolves. So, we would not expect it to have a measurable impact on economic growth over that period. I would point out that over the period from 1992 to 1997, we actually had a 3.5 percentage point withdrawal of fiscal stimulus from the economy, and growth has been quite strong.

> Mr. Shields raised a question about the supervision of mutual funds. Mutual funds fall under the supervision of the Securities and Exchange Commission. They are supervised in the same way as other stocks are supervised. The main thrust of supervision is to ensure that adequate information is available to the public in evaluating the expected returns and the value of the assets. He also asked a broader question in terms of the adequacy or appropriateness of the supervisory system in the United States. I would think that the United States could be characterized as having one of the best, and one of the most sophisticated, supervision systems in the world. At the same time, it should be recognized that financial markets have proven to be very dynamic and innovative, and there may be a tendency at times for supervision to lag somewhat behind developments in the market.

Mr. Grilli remarked that, according to the staff's medium-term projections, the economy would continue to grow at the same rate until 2002, that is, at potential, which would be quite remarkable. The absence of cyclical factors—which was implicit in the projections—could be because of the difficulty of forecasting cyclic developments or because the staff believed that the business cycle had ceased to exist. He would like the staff's clarification on that point. On the dollar's appreciation, he wondered whether that had an impact on U.S. trade policy.

Mr. Shields wondered in view of the growth of mutual funds and the existence of multiple regulatory agencies in the financial sector, whether there were problems relating to information flows on mutual funds between the various regulatory agencies.

Mr. Levy asked whether there were problems with respect to supervision of offshore mutual funds.

The staff representative from the Western Hemisphere Department responded that, if appropriate fiscal and monetary policies were pursued, the economy could be expected to operate at full employment. That did not mean that the business cycle was dead, but it was difficult to identify a particular external shock that would produce cyclical effects. There was always room for policy mistakes; indeed the staff was concerned that monetary policy might not be tightened quickly enough.

Mutual funds were clearly under the jurisdiction of the Securities and Exchange Commission; hence, the problems associated with divided supervisory responsibility in other parts of the financial sector did not arise, the staff representative stated. Given the entry of a large number of less sophisticated investors in mutual funds, there might be room for improving the availability of information in the form of prospectuses and other financial reporting requirement established by the Securities and Exchange Commission. Offshore funds were outside the purview of U.S. supervisory agencies. However, the Securities and Exchange Commission did supervise stock brokers, and it could intervene if there was some systematic defrauding of investor's through the shifting of funds overseas.

The Deputy Director of the Western Hemisphere Department observed that if the appreciation of the dollar were to be reversed, that could put pressure on domestic resources. Monetary policy would need to be tighter, because at present the strong exchange rate was dampening pressure on domestic resources and helping to contain price pressures. In order to ensure that the reversal of the appreciation did not result in undue increases in interest rates or inflation, there would also need to be additional fiscal tightening.

The staff representative from the Western Hemisphere Department noted that the appreciation of the dollar had not led to any significant increase in protectionist pressures. With respect to the strength of the stock market, it was puzzling that the resulting increase in wealth had not been reflected thus far in higher consumption. Part of the explanation might be that investors were investing a larger part of their savings in stocks in order to maximize returns. Such behavior would help to resolve what was known as the equity premium puzzle, that is, the difference between returns on bonds and stocks tended to be greater than one would expect given the difference in risk between the two assets. In response to a point raised by Mr. Kaeser, he would note that a reduction in the capital gains tax, rather than fueling the stock market "bubble," might actually have the opposite effect of deflating the market, by giving investors an incentive to sell stocks that they had accumulated. The effect would be to alter people's expectations of gains in the stock market, thereby slowing the flow of funds into the stock market.

Ms. Lissakers remarked that, given uncertainties related to the future of Social Security, people were increasingly investing their savings for retirement purposes in funds that were invested in the stock market. That might explain why the increase in wealth from stocks was not being reflected in higher consumption.

In responding to a comment by Mr. Kaeser that much of the favorable performance of inflation appeared related to the pricing behavior of firms, the staff representative from the Western Hemisphere Department noted that the staff's empirical analysis of firms' pricing behavior had not produced statistically significant results, but the staff would continue to work on that question.

Current estimates suggested that about 50–70 percent of U.S. currency in circulation was held abroad, that is, about $225–275 billion the staff representative stated. The United States gained about $15 billion, per year in seignorage on the foreign holdings of its currency. Given the relatively small size of currency holdings relative to the stock of assets in the U.S. market—for example, currency in circulation represented about 35 percent of M1—the Federal Reserve could easily offset any shifts in foreign holdings of dollars so that there would be minimal impact on monetary policy and inflation.

The Deputy Director of the Policy Development and Review Department said that the staff had taken note of the suggestion for further work on the question of income distribution in the United States. The May 1997 *World Economic Outlook* had addressed that question in the context of the discussion on globalization. One key finding of the *World Economic Outlook* was that increasing wage inequality—which had largely been reversed—reflected mostly technological advancements, which had the effect of enhancing job and income opportunities for skilled labor. Given the flexibility of the U.S. labor market, particularly in comparison to labor markets in continental Europe, any adjustment in the labor market was effected through lower wages, while in continental Europe, the adjustment occurred through higher unemployment. That was the reason for the higher unemployment in continental Europe compared to the United States. Those continental European countries that had introduced greater flexibility in their labor markets, such as the Netherlands, had experienced a decline in unemployment. The OECD had done useful work in that area and the staff would incorporate its findings in its own work.

The staff's understanding was that the Administration's Africa Initiative aimed at supporting countries that made strides in liberalizing trade and investment, investing in human resources, and improving policy management and governance, the Deputy Director stated. Those countries would benefit by having greater access to industrial country—particularly U.S.—markets for their exports, and the United States would consider debt reduction, investment support, and technical assistance to promote liberalization in those countries. The various features of the Africa Initiative were still at the proposal stage. The legislative bills on improved market access would probably be introduced later that year, according to the staff's information.

Mr. Zoccali made the following statement:

Allow me to join the chorus of praise for the U.S. authorities' skillful management of their economy, which has delivered unprecedented expansion in an environment of low inflation exceeding all expectations.

The staff should also be commended for the quality of the papers presented, which serve to underscore both a high degree of convergence of views and an absence of near term policy dilemmas. In this regard, the foundations for further sustained and balanced growth, as Ms. Lissakers convincingly argues in her buff, appear to be well in place with growth for the rest of 1997 around potential.

The challenge, in our view, is to keep the good times rolling. To this end, we attach greatest importance to being able to stay ahead of the markets. This means maintaining a forward-looking strategy for dealing also with the structural sources of uncertainty, rather than trying to second-guess an unquestionably credible FED on the appropriate path for short-term interest rates. At this stage of the discussion, given the well-articulated observations and staff replies, I will confine our comments to just four points.

First, probing "the lower reaches of Non Accelerating Inflation Rate of Unemployment (NAIRU)" entails risks. Avoiding sudden shifts in investor confidence should remain the priority of U.S. policy-makers; not least because of the systemic consequences of a larger than anticipated monetary correction via its impact on the direction of capital flows, as evidenced in 1994. Moreover, given the size of the United States' savings/investment imbalance and net debt position, the principal macro-economic issue is nurturing the still low rate of net national savings.

In this regard, maintaining the agreed pace of deficit-reduction within the framework of the Bipartisan Balanced Budget Agreement (BABA) would not be an excessively ambitious goal in the context of continued revenue windfalls that may be associated with higher potential output growth. Conversely, one should not overestimate the ability to put the major sources of unfunded liabilities, namely the Medicare and Social Security Systems, on sounder footing if economic conditions return to a more conventional, albeit extended, cyclical pattern. Emphasis, in any event, should also be placed on the continued improvement in the quality of public expenditure, particularly on human capital development, to ensure adequate skills and contain a widening disparity in the distribution of incomes and opportunities. In addition, we would echo staff's and Mr. Levy's word of caution with respect to the tendency of the tax system in recent years way to move in the direction of targeted tax incentives which impact on tax expenditures, narrow the tax base and make the income tax system increasingly less transparent and efficient.

Second, with respect to trade policy, we consider that the United States has played a pivotal role in advancing multilateral trade liberalization and the openness of the international trading system. However, with the Cold War over and the rapid technological advances, that have dramatically increased not only productivity but also skill-obsolescence and job insecurity, and the greater competition from globalization, the challenge of convincing its citizens of the benefits of international trade is no doubt more difficult. Nevertheless, it is essential that the United States persist with such efforts. In this regard, we welcome the policy shift in favor of the WTO dispute settlement process and are confident that less reliance on unilateral trade measures will serve to strengthen global economic cooperation. Similarly, sectoral and regional trade agreements within a multilateral context and early approval of fast-track authority can contribute to reinvigorating the momentum for further liberalization. As noted by Ms. Lissakers, the synergies and positive spill-over effects, particularly in terms of new export opportunities to fast-growing developing country markets, should not be overlooked.

Third, staff raised the double-faceted character of giving priority to avoiding unproductive expenditure. We would endorse, in this regard, a more concerted effort to restrain promotion of military sales on the part of major exporters so as to reduce the likelihood that security considerations end-up undermining attainment of macroeconomic and social goals.

Finally, with respect to Overseas Development Assistance, it is worrying that yet another major donor is trimming the volume of its assistance. Admittedly, effectiveness is as important as quantity. Nonetheless, those that are better positioned to reap the benefits of globalization should ensure that the gains are more widely shared, by helping in particular to finance a faster integration into the world economy of those lower-income countries making an earnest effort at adjustment and reform.

In closing, we wish the U.S. authorities continued success.

Mr. Kafka made the following statement:

In excellent papers, Ms. Lissakers and the staff have shown how effective fiscal and monetary policies have helped to make the current economic expansion of the United States one of the longest in the period since World War II, bringing the unemployment rate down to a particularly low level, together with very low inflation rates. This recent performance of the economy, characterized by the combination of low unemployment and low inflation, has been extraordinary.

Without doubt, this economic situation reflects some temporary factors that have helped restrain inflation, such as the slow rise in labor costs, the appreciation of the U.S. dollar, and increased external competition with weak growth in other major countries. But it also reflects the authorities' exemplary macroeconomic management. Administration and Congressional actions to curtail budget deficits have permitted long-term interest rates to move downwards, and deregulation in a number of industries has fostered competition—e.g., telecommunications, motor and rail transport, utilities, and finance. Also, the flexibility of U.S. firms in decisions to expand plant, lay-off surplus workers, and develop new products have made the economy more efficient. However, a piece of the puzzle is missing and has to be explained by other factors, such as technological changes. These changes have helped to make possible that productivity growth, which often declines as expansions mature, has not followed that pattern. That may still be a bit of a puzzle or a problem of statistics.

The temporary factors could, conceivably, create problems in the period ahead, in particular, the economy is operating at a high level of resource utilization. Moreover, unit labor costs could begin to press on profit margins and prices. Although the June unemployment rate slightly exceeded that for May. Thus, the monetary authorities must remain particularly vigilant and be prepared to raise interest rates, if that should prove necessary, at very short notice.

Important progress has been made in reducing the fiscal deficit since 1993, and it is projected to decline further in 1997. The recent agreement between the Administration and Congress aiming to balance the budget by 2002 and maintain a balanced budget over the period to 2007 is welcome. However, the agreement relies on substantial further cuts in discretionary spending and only addresses the near-term financial problems of the Medicare system. The longer-term problems of Medicare and those of the Social Security System remain to be addressed. Also, the U.S. current account deficit remains large and therefore, further tightening of fiscal policy over the medium term to help increase national savings continues to be important.

The U.S. authorities support multilateral and regional trade liberalization; however, at times they have had recourse to unilateral trade actions undermining these cooperative efforts. Nonetheless, recently the United States have used extensively the WTO's trade dispute-settlement procedures. We join the staff in encouraging the authorities to make more active use of existing multilateral procedures, in preference to unilateral actions.

The United States has played a decisive and welcome role in ODA. However, this assistance has declined to around 0.1 percent of GDP in 1995 and 1996, and the 1998 Budget proposed only stabilizing such assistance at this low level. We hope that the authorities can ensure that ODA does not fall further and that energetic efforts are made to reverse its decline.

In sum, the U.S. authorities should be highly commended for their policy efforts and the resulting excellent performance of the U.S. economy.

Mr. Toribio has suggested that U.S. performance may have been even better. That would, of course, be welcome. But it should not change our conclusions—we should rather, as others have said, gratefully accept the enhanced likelihood that the objectives of the authorities can be realized.

Mr. Han made the following statement:

I join previous speakers in commending the authorities of the United States for their good performance in managing the economy in recent years, and thanking staff for the well-written report and illustrative background papers and Ms. Lissakers for her very helpful statement. The high growth rate (in particular, the surprisingly high growth rate in the first quarter of 97) together with the co-existence of a low inflation rate and unemployment rate, add more confidence, and some concerns as well, to the development of the U.S. economy. I broadly agree with the main thrust of the staff's appraisal and previous speakers' comments, and would like to make a few remarks on some macroeconomic policy issues for emphasis.

The fact that the economy has remained in good shape for several years suggests the effectiveness of the authorities' medium-term policies, among which the federal fiscal deficit reduction effort is very much appreciated. I am glad to see the deficit/GDP ratio reduced to the lowest level in more than 20 years, and welcome the agreement between the Administration and the Congress on a broad plan to balance the federal budget by FY 2002. I share the staff's view that the immediate challenge in this regard is to implement the plan by drawing specific measures, and taking into account the timing of spending cuts and tax cuts, so as to enhance the plan's creditability.

Up to now, there are few doubts that the Fed's preemptive monetary policy has done a good job in curbing inflation and fostering economic growth. Making preemptive policy, as Mr. Meyer, Governor of the Fed, indicated in his July 23 testimony, requires an artistic and scientific mind set, especially in an environment of rapid technological and social change. Actually, it is a real challenge to the monetary policy makers. Scientifically speaking, to model and simulate the running of the economy, is already a difficult job; you have to be an artist as well, making beautiful judgments on the development of the economy with your own characteristics. Moreover, the monetary policy makers need to be strong to assume tremendous responsibilities. In a word, they should be superpersons to advance a prompt policy adjustment if necessary, in the changing world because of the time lags of monetary policy implementation effects.

Turning to the structural issues, it is very impressive that the U.S. labor market has been very quiet while the growth rate embarks on a high level. Job uncertainty is a very good explanation for this phenomenon. With the unemployment rate around 5 percent at current level, and inflation rate remaining at 2.4 percent, naturally it occurs to my mind— what is the real lower end of the natural rate of unemployment? Maybe more weight should be put on the effect of technological progress on the behavior of the labor market while computing the natural rate. The same is true with the computation of the production capacity.

As regards the financial market reform, in view of the large amount of international capital flows and the increasing competition in the international financial markets, it is quite understandable that there is considerable interest in repealing the Glass-Steagall Act. The staff may also want to comment on the implication of the possible enactment of legislation for the international markets and for financial regulation and supervision as well.

On the external sector, I concur with the staff that the appreciation of the U.S. dollar over the past two years mainly reflects relative cyclical positions and policy developments in the major countries. It is also worth noting the real appreciation of the dollar is reflected against the backdrop of currency fluctuations recently in the South-east Asian region.

I join others in welcoming the policy shift of the authorities toward the resolution of trade disputes on a multilateral basis and in the meanwhile, once again urge the authorities to move forward in trade liberalization in the traditional areas of textiles, clothing, and agriculture. In the area of ODA, I am disappointed to see another year of a historically low budget for the Administration. It is surprising to see the United States, the largest economy in the world and the best performer among the industrial countries in recent years, ranks lowest in ODA outlays, in terms of ODA/GDP ratio. I associate myself with other speakers in encouraging the authorities to stop the recent trend in this regard.

With these remarks, I wish the authorities every success in keeping the current momentum of favorable economic development in the future.

Mr. Hammoudi made the following statement:

The U.S. economy continues to grow at an above-potential rate with subdued inflation, progressively dispelling concerns about inflationary pressures. Underpinning the surge in activity has been a renewed round of residential construction, strong consumption demand, and continuing growth of business fixed investment. The unemployment rate has recently moved to the lower end of the estimated range of the natural rate of unemployment, which combined with the declining core consumer price index, has given rise to the conjecture that natural rate of unemployment may be overestimated. We join other speakers in commending the authorities for their superb economic performance, as described in Ms. Lissakers' informative statement.

Fiscal consolidation is progressing well and the budget deficit in relation to GDP in 1996 is the lowest since 1974. The fiscal position has improved dramatically as a result of stronger growth performance and the authorities' tightened fiscal stance. The supply has proven surprisingly resilient in face of increasing demand due to a quiescent labor market and improved labor productivity. Indeed, despite high levels of resource utilization, these have resulted in restrained impact of upward pressures on wages and salaries.

However, some risks certainly exist. The major risk is that the demand for labor compensation may heighten and cause the emergence of inflationary pressures and endanger the current economic expansion.

Furthermore, the balanced budget agreement, would enhance the credibility of the authorities' policy framework. We are encouraged by the plan's objective to cut deficit mostly toward the end of the consolidation period. Moreover, as indicated by Ms. Lissakers, the consolidation plan will strengthen savings. However, we agree with the staff that the authorities should bring forward the spending cuts and delay tax cuts, within the terms of the plan, to help achieve an earlier reduction in the deficit. This would also help to increase the margin of maneuver to face any slowdown in economic activity.

As stated in the staff papers, two major initiatives—health care and savings—remain in order to prepare the U.S. economy to meet the challenges after the turn of the century. First, for health care, as the baby-boom generation retires, the entitlement spending will rise rapidly and budget deficit will increase. In this regard, we support the staff's proposal to spread the burden more equitably through a combination of increases in payroll tax and costs to beneficiaries, constraints on payments to health-care providers, and increase in age of eligibility. Regarding the social security system, although the problems—not substantial in magnitude—are similar actions needed in the immediate future, if its sustainability and solvency are to be secured in the long-term. Second, for savings, it is vital to raise the level of savings to improve the long-term growth potentials of the U.S. economy. Also, increased saving rate can eliminate the need for the correction of external imbalances through exchange rate adjustments that may lead to crowding out of investment. Furthermore, measures to boost saving performance over the long-run are necessary to compensate for expected downward pressures associated with the shift in the elderly dependency ratio as this shift increases the number of dissavers relative to savers.

The FED authorities acknowledge that the economy is now operating at levels where price pressures could emerge. Moreover, they recognize that factors that had been important in restraining price increases in the recent past may become less effective in the future. However, we would agree with Ms. Lissakers that at present labor costs are moderate and employment cost index is held down by declines in nonwage benefits. But, many of these factors may turn out to be of transitory nature and the pressures on labor market and prices may soon get back to their traditional relationship. Therefore, preemptive and appropriate monetary policy action against the emergence of inflationary pressures may substantially reduce the risks to the national and global economy in case of swift and significant interest rate hikes.

On external policy, the U.S. authorities should be commended for their initiatives and continuous support for multilateral trade liberalization. Moreover, it is encouraging to learn that the authorities are planning to rely more on WTO procedures to settle trade disputes. We join other speakers in calling on the authorities to push forward more quickly with trade liberalization in sensitive sectors such as agriculture and textile, thereby setting an example for other major markets. Concerning the official development, like other speakers, we would like to call upon the authorities to avoid further cuts in their external assistance and to reverse its declining trend toward achieving the UN target goal of 0.7 percent of GDP. It is most regrettable to see the United States at the bottom of the list of ODA ratio to GDP amongst DAC countries as shown in table 2 of the selected issues paper.

With these remarks, I would like to wish the authorities every success in their adjustment efforts.

Mr. Morais made the following statement:

I want to join other Directors in commending the authorities for the skillful management of the U.S. economy. The results of these efforts are clearly illustrated by strong employment generating growth in a low inflationary environment.

Given extensive comments that have already been made, I only wish to address two issues regarding the outlook for policy formulation.

Given the high degree of resources-utilization, the expectation that those factors that have been restraining price increases will become less prevalent and my support of the view that moderate adjustments of policy will benefit a continuation of the current upswing, I agree with those who believe that a further small tightening of monetary policy would be a prudent course of action.

On fiscal policy, I commend the authorities for the substantial progress in reducing the deficit and reaching agreement on balancing the budget. I specifically welcome the inclusion of a number of measures to ensure achievement of the targeted deficit reduction.

Countries in my constituency appreciate the support of the U.S. government to promote economic development in our region. We also welcome the most recent initiative that will recognize the commitment of our authorities to foster sustainable growth by granting easier access to U.S. markets and investment. Like other Directors, we are concerned about the decline in official development assistance in recent years, and urge the U.S. authorities to recognize the important role it has to play in this area.

With these remarks, I wish the authorities every success in their endeavors.

Mr. Joyosumarto made the following statement:

I find the set of papers provided by staff for today's discussion to be quite readable and well-focused. The statement from Ms. Lissakers has also been insightful. All in all, the U.S. authorities are to be commended for their prudent macroeconomic policies which has resulted in one of the most sustained periods of growth of the US economy.

Such a sterling performance naturally invites several questions. How fast can the U.S. economy now grow? Has there indeed been a structural shift in the economy that has allowed the level of potential output for the U.S. to increase and that of its NAIRU to fall? While the background papers have been helpful, more explicit views of staff on this current debates would be useful.

On the monetary policy, we tend to concur with the present stance of the authorities in abstaining from any monetary tightening given the absence of any inflationary pressures. The need for vigilance goes without saying and the recent track record of the Federal Reserve in this respect has been note-worthy. Given their credible performance thus far, I do not support that the Federal Reserve should change its present approach for a monetary policy based on a different approach (such as inflation targeting).

On fiscal policy, the continued narrowing of U.S. fiscal deficits is indeed welcomed as it contributes toward the lowering of global interest rates. We agree with the staff that now is an opportune time for greater efforts to be made toward achieving a balanced budget or even a fiscal surplus in the very near term. The improvement in public savings would certainly be needed given that household savings have been slow to rise and that the aging of the population is an event that cannot be avoided.

Finally on the ODA, I believe the United States can do more. While its actual dollar contribution is the second largest after Japan, Table 2 on page 108 of the paper on selected issues indicates that the US has the lowest ODA as a proportion of GNP among the industrialized economies. We are encouraged that the U.S. authorities are thinking to find new approach to increase the effectiveness of the assistance. On this matter, I would like to quote the editorial of *Washington Post* today (July 28, 1997) as follows: "— after the end of the cold war, compelling reasons for the U.S. to remain engaged in the world and to encourage development in its poorer corners. Foreign aid has played an important role in Asian and Latin American countries, bringing millions out of poverty and creating more fertile ground for democracy. It could do the same in Africa and the formerly communist world, helping donors as well as recipients."

With this remark, I wish the U.S. authorities further success in the future.

The staff representative from the Western Hemisphere Department noted that the two key issues in the repeal of the Glass-Steagall Act related to the ability of banks to sell securities and insurance, and investment by banks in nonfinancial firms and ownership of banks by nonfinancial firms. On the second point, there was disagreement between the Federal Reserve and other supervisory authorities in the U.S. government on what would be the best organizational form for such combined banking and nonfinancial firms for supervision purposes. With respect to the issue of participation of banks in the securities market, some of the pressure that the large banks had been placing on the authorities for repeal of the Glass-Steagall Act had diminished because of regulatory changes. The Federal Reserve, through its regulatory actions, had increased the ability of large banks to participate in the securities market. In terms of the implications for international markets, the repeal of the Glass-Steagall Act would be another step in supporting the increased globalization of markets.

After adjourning at 1:05 p.m., the meeting resumed at 2:30 p.m.

Ms. Lissakers said that she wished to thank Directors for their useful and complimentary remarks on the U.S. economy. She also wished to thank the staff for its useful work, in particular its analysis of some of the puzzling features of recent economic performance. The section on the Phillips curve and job insecurity in the background paper was particularly useful, given the attention that the subject had received in public policy debates. The staff's finding suggested that perhaps too much emphasis was being placed on job insecurity as a factor in restraining wage cost pressures—which is welcome from both an economic and political perspective. Their findings raised new questions, which she hoped the staff would address in the context of the next Article IV consultation.

There was no reason to believe that U.S. monetary authorities were in any way complacent, Ms. Lissakers continued. Her reading of Chairman Greenspan's Humphrey-Hawkins testimony was somewhat different from that of financial markets. In her view, Chairman Greenspan had been extremely cautious; he had stressed that the factors that had led to the good inflation performance recently—such as the strength of the dollar, the favorable commodity prices, and reductions in nonwage costs—were temporary, and likely to be reversed. On the labor supply side, the participation rate had increased steadily, but that was unlikely to continue. The legislation on immigration could have some impact on labor supply, and the growing resistance to overtime could affect wage costs. The recent strike at General Motors was indicative of the developing strains on the supply side of the economy. The Federal Reserve was well aware of all those factors.

The Federal Reserve, and others, were trying to understand various "puzzles" relating to recent economic performance, particularly with respect to productivity and GDP measurement. Ms. Lissakers noted. The staff's analysis of the income versus expenditure measures of national output was interesting and illuminating. Those "puzzles" had been discussed at length by the staff and the authorities, and her authorities had been quite candid in stating that they did not know what the answers were. While it was possible that there were permanent structural changes in the economy, her authorities were not certain that that was indeed the case, and monetary and fiscal policies were being implemented based on traditional assumptions.

The baseline assumptions underlying the budget agreement were very conservative, both on the growth and revenue side, Ms. Lissakers continued. Evidence from the first half of the year suggested that on both counts performance this year would be better than assumed under the baseline scenario.

A discussion on the future of the entitlement programs was under way, and there was a strong bipartisan commitment tó address the problems of Medicare and Social Security, Ms. Lissakers said. The focus currently was on the balanced budget agreement, and the authorities intended to address the problems of the entitlement programs later. There was already considerable agreement about the nature and magnitude of the problems, and there was a broad understanding of the various alternative solutions. She was confident that the problems would be addressed expeditiously in the next few years.

She wished to note that there were two significant changes in the tax structure in 1993, Ms. Lissakers stated. They were an increase in tax rates on upper income groups and an earned income tax credit for lower-income working class families. The first had resulted in substantial increases in tax revenues in the preceding few years, and the second had helped to narrow the post-tax income gap between lower- and higher-income groups. As to the suggestion to introduce consumer taxes and value-added taxes, indirect taxes were highly regressive, particularly when they fell on essential items such as food and clothing. In Europe, unlike the United States, there were significant social transfers to offset the regressive features of the high value-added taxes while the U.S. had lower transfer and less regressive taxation. There were merits in both the U.S. and European approach to taxes and transfers. While complaints were heard about the tax system in the United States, there appeared to be no strong public push for a fundamental change in the tax system.

Mr. Toribio's remarks suggesting that the strength in the stock market was perhaps rational were interesting and related to the "puzzles" of recent economic performance, Ms. Lissakers noted. As the 1987 stock market crash had had a limited impact on spending, it was likely that if there were to be another decline in the market of the same magnitude, the impact would probably not be substantial. It would take a 2,000 point drop in today's stock market to equal the magniture of the 1987 crash.

U.S. exports continued to grow strongly despite the considerable appreciation of the dollar, Ms. Lissakers stated. The short-term impact of changes in the exchange rate on the current account deficit was uncertain. While the low savings rate explained in part the widening of the current account deficit, it should be noted that the U.S. current account deficit would have been narrower if there had been stronger growth in United States' trading partner countries, particularly Europe and Japan.

The authorities were trying to make U.S. official development assistance more effective by directing assistance to countries that were undertaking meaningful structural reform and encouraging private financial flows to those countries, Ms. Lissakers concluded.

Mr. Taylor, noting the funding problems that were on the horizon for Social Security and Medicare, asked whether the authorities had any plans to keep the budget in balance over the medium term.

Ms. Lissakers responded that one reason to achieve a surplus was to deal with the funding problems of Social Security and Medicare, caused by the aging of the population. However, the current political debate was about balancing the budget by 2002 and not about achieving a surplus in the medium term. Moreover, the funding problems of the entitlement programs were much less serious than in other industrial countries, and would not surface until later. The Administration and Congress had agreed on certain interim measures as part of the balanced budget agreement, but they recognized that those measures would not address the problem fully and that a permanent solution was needed.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They congratulated the U.S. authorities on their skillful management of economic policies, which had yielded remarkable results, and noted in particular their success in bringing the economy to full employment while containing inflationary pressures. Directors discussed the possible factors underlying the exceptional performance of the economy; while that would require continuing further study, they mentioned the likely role of underlying improvements in long-term economic efficiency, reflecting the pervasive application of recent technological advances, and the flexibility of labor and product markets, as well as some temporary factors that had restrained inflation. Several Directors also noted that, in assessing the recent performance, account should also be taken of the uncertainties associated with problems in measuring output and prices. Directors considered that continued adept handling of monetary policy and further progress in reducing the budget deficit would establish a firm basis for sustaining the current economic expansion.

Directors noted that an immediate policy challenge was to guard against the emergence of inflationary pressures. In view of the high degree of resource utilization, the underlying strength of aggregate demand, and the likelihood that factors that had restrained inflation in the recent past including slowly rising labor costs, the appreciation of the U.S. dollar, and increased external competition with weak growth in other major countries would diminish in the period ahead, Directors agreed that the U.S. monetary authorities would need to remain vigilant.

Directors considered that a forward-looking approach to monetary policy was essential, given the lags with which the monetary policy affected output and prices. Several Directors agreed with the authorities that there appeared to be no immediate need to tighten policy, given the present expected evolution of economic indicators. Those Directors, however, recognized that further interest rate increases could be required in the future if economic growth turned out to be stronger than expected. Many other Directors, however, cautioned that an undue delay in tightening monetary policy could undermine the current expansion by increasing the risk that aggregate demand pressures would build, and, from an international perspective, such a policy development could have disruptive effects on other countries, as more substantial increases in interest rates might be required subsequently to contain inflation. Those Directors took the view that a further, moderate, and preemptive tightening was necessary to guard against the emergence of inflationary pressures. Some Directors expressed the sense that if stronger productivity growth had caused an upward shift in potential growth, that consideration would have important implications for assessments of the current stance of monetary policy. With regard to setting formal inflation targets, most Directors saw little need to change the current monetary policy approach, noting that the Federal Reserve's policies were already credible.

Directors considered that progress in reducing the budget deficit in recent years and the agreement between the Administration and the Congress to balance the budget by fiscal year 2002 had created a favorable medium-term outlook for U.S. fiscal policy. The remaining challenge was to implement and adhere to the terms of the agreement. In that context, some Directors urged the Administration and the Congress not to use prospects that revenue might be stronger than expected as a pretext to ease the terms of the agreement, and thereby lose a historic opportunity to bring the budget into balance on a structural basis. Many Directors also indicated that a faster pace of fiscal consolidation by bringing forward spending cuts and delaying tax cuts than that envisaged in the balanced budget agreement would help to contain demand pressures and enhance the plan's credibility, as well as increase the latitude for countercyclical fiscal policy. On the composition of fiscal adjustment, a few Directors expressed concern that the substantial cuts envisaged in discretionary spending might be difficult to implement given the substantial compression of such outlays in recent years, and the Administration's desire to raise spending on education and training, and they noted, therefore, that deeper reforms of the entitlement programs would have been desirable. While it was noted that discretionary defense spending was declining more rapidly than other nondefense-related discretionary expenditures, a few Directors, nonetheless, saw the need to reduce unproductive expenditures, including the reallocation of expenditures from defense to nondefense priority areas.

While the medium-term fiscal outlook was generally viewed as favorable, Directors cautioned that the aging of the U.S. population would place increasing strains on the Medicare and Social Security systems, with significant implications for fiscal policy over the longer term. Prompt efforts were required to reduce the financial burden that those programs would otherwise impose in order to avoid more draconian measures in the future. Directors supported the Administration's intention to establish a bipartisan commission to develop a plan to address Medicare's longer-term finances and encouraged the U.S. authorities to act quickly. While the financial problems of Social Security were less immediate, Directors nonetheless noted that a plan to shore up the system's longer-term financial position should be implemented as soon as possible.

A few Directors expressed concern that, after the simplification achieved in the Tax Reform Act of 1986, the U.S. tax system was becoming increasingly complex and that elements of the balanced budget agreement would continue that trend. Targeted tax incentives tended to narrow the tax base and make the income tax system less efficient and transparent. Directors encouraged the authorities to give consideration in the coming years to simplifying the income tax system and reducing distortions in order to enhance economic efficiency.

Over the preceding two years, the dollar's appreciation had helped to moderate aggregate demand and to limit inflationary pressures in the United States, and had also helped to sustain growth in other countries. However, the strength of the U.S. economy relative to those of other major countries, and the appreciation of the dollar, were contributing to a widening in the external current account deficit, and the persistence of large U.S. current account deficits and growing international indebtedness would be a concern over the medium term. Directors noted that the best means of addressing that problem would be to boost national saving through continuing improvements in the fiscal position, with attendant benefits for both the United States and the world economy.

Directors welcomed U.S. initiatives to advance trade liberalization, and encouraged the authorities to continue that effort. Directors also welcomed the preparedness of the United States to use the multilateral dispute-settlement procedures of the World Trade Organization for settlement of trade disputes. Directors urged the authorities to be cautious in their use of unilateral trade actions, and encouraged the United States to exercise its leadership role by pushing forward more quickly with trade liberalization in traditionally sensitive sectors, especially agricultural products and textiles.

Many Directors regretted the decline in U.S. official development assistance relative to GDP in recent years, and urged the authorities to reverse that trend. They also encouraged the authorities to meet their commitments to international financial institutions.

A few Directors also urged the United States, and other major countries, to work with the Fund to ensure that arms sales to developing and transition countries did not undermine efforts to strengthen macroeconomic policies in those countries.

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

4. NIGER—1997 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY—SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1997 Article IV consultation with Niger and Niger's request for the second annual arrangement under the Enhanced Structural Adjustment Facility (ESAF) (EBS/97/131, 7/14/97). They also had before them a policy framework paper for the period 1997–2000 (EBD/97/85, 7/14/97) and a statistical annex (SM/97/188, 7/14/97).

Mr. Barro Chambrier made the following statement:

Niger has shown its determination to pursue the implementation of strong policy measures in the framework of an adjustment program covering the period 1996/97, despite a difficult internal and external environment. As a result, most quantitative criteria and structural benchmarks for end-December 1996 and end-March 1997 were observed. However, the nonobservance of the performance criterion relating to the wage bill was due to a delay in implementing a new civil service salary grid, and the criterion on external arrears was not observed either, largely because of a delay in the disbursement of external financial assistance expected in the program.

Niger's overall economic performance has improved somewhat, the rate of real GDP growth increased close to the program target in 1996. Inflation slowed down significantly and the external current account deficit (excluding official transfers) was reduced. The overall fiscal deficit on consolidated government transactions (on a commitment basis and excluding grants), was reduced by over 3.0 percentage points of GDP to a level equivalent to 5.4 percent of GDP in 1996. Progress was also achieved in the structural area, particularly with the implementation of measures that are expected to contribute significantly to an increase in tax revenue. This strengthening of the economic performance was largely the result of a successful implementation of financial and structural measures. In addition, efforts have been pursued in the area of labor market liberalization, the establishment of a regulatory framework for the privatization program, and the streamlining of the civil service.

My Nigerien authorities are aware of the challenges that will face the country during the medium-term and beyond. They, therefore recognize that to address these challenges, a further strengthening of policies will be required.

In that context and consistent with the medium-term adjustment program, which assigns a central role to fiscal consolidation efforts, the 1997 program aims at bringing the budget deficit further down through revenue-increasing and expenditure-containing measures. On the revenue side, the authorities seek to broaden the tax base, improve tax administration and introduce new taxes measures, including the rationalization of petroleum taxation. In addition, the introduction of a statistical tax on exports is contemplated within the context of the regional harmonization of tax systems. Reflecting the impact of these measures, the revenue to GDP ratio is expected to increase by 1 percentage point of the GDP in 1997.

On government spending, efforts will be made to better control and contain total expenditure and to ensure an adequate allocation of resources to priority sectors. To this end, the government has already adopted measures including a new civil service salary grid. The government has also decided to freeze the recruitment of civil servants, except for those working in social sectors. In addition, efforts are being made to limit transfers and subsidies. On capital outlays, the government intends to give high priority to the investment projects, which are intended to facilitate the development of private sector activity. In this context, systems for projects programming and investment planning will be revised. Regarding other expenditure items, the authorities believe that the accumulation of domestic payments arrears by the government has partly hindered the development of private sector activity. To address this problem, they are making a special effort to settle domestic payments arrears through adequate budgetary appropriations. In addition, they intend to strengthen the mechanism for preventing future accumulation of such arrears.

Monetary policy conducted in the context of the West African Monetary Union will remain prudent and will continue to rely on the use of indirect instruments. Moreover, in close cooperation with other members of the Union, Niger will participate in efforts to maintain the international reserves of the regional central bank at a comfortable level. To conduct an efficient monetary policy, the authorities are of the view that a well-functioning financial sector is of paramount importance. To further improve the financial health of commercial banking sector, they are now implementing a number of restructuring plans for a number of banks which are still facing difficulties. In addition, they will continue to adhere to the recommendations of the Regional Banking Commission, particularly on commercial banks.

On structural issues, efforts are being pursued to further the public enterprise and civil service reforms. In that context, the authorities have envisaged measures to mitigate the short-term effects of these reforms on the most vulnerable social groups. Meanwhile, the government is contemplating the transfer of the existing storage facilities owned by SONIDEP to the private sector. In addition, a majority share of telecommunications company will be offered for sale by mid-1998. On civil service reform, a census is scheduled for completion next month. Furthermore, the government envisions diversifying agricultural production with the promotion of livestock and export crops and to intensify research and development of small-scale irrigation against the scarcity of rainfall and the extension of the Sahara desert.

Finally, my Nigerien authorities would like to reiterate their commitment to the adjustment process during the years ahead. In that context it is important to know that Niger's success will critically depend on the availability of external concessional assistance including debt rescheduling and debt relief. It should be emphasized that Niger is presently faced with a heavy debt burden which is partly constraining its medium-term economic growth prospects. This situation requires quick actions on the part of its external creditors, including the Fund. My Nigerien authorities would also like to express their appreciation to Management and the staff for their invaluable support and advice.

Mr. Kwon made the following statement:

First of all, I would like to commend staff for the excellent job they have done in preparing the papers before us today, and also to congratulate the Nigerien authorities on the great improvement in Niger's economy since implementation of the ESAF program. As mentioned in the staff paper, most of the quantitative and qualitative performance criteria seem to have been met, with very few exceptions. In 1996, real GDP picked up to 3.3 percent, albeit, a little short of the program target of 3.6 percent, while inflation has curbed down to 5.3 percent. Both government and current account deficits have also decreased. Cumulatively, these performances indicate that, for the most part, Niger's economy remains on track.

Under these circumstances, staff have emphasized several points in the medium-term adjustment strategy which include, fiscal consolidation on both revenue and expenditure sides, adequate credit room for the private sector, and privatization and alleviation of donors' concerns about governance issues.

Basically I agree with the staff's appraisal and their policy recommendations. However, I have a few questions where some light should be shed. Even after recent improvements, Niger remains one of the least developed countries characterized by a very low per capita income of a meager \$230, a high population growth rate of 3.4 percent, a mostly agriculture-based economy—where the elementary sector takes 40 percent of GDP, a very high illiteracy ratio, and a very low investment and domestic savings ratio of

9.5 percent and 4 percent of GDP respectively. In short, it is a subsistence level economy in many respects, even though it recently achieved stabilization in macro variables.

Under these circumstances, even though Niger's economy is on track to achieve all of its medium-term macro targets successfully by the year 2000, it will still remain one of the least developed countries at that time. I do not underestimate the importance of macroeconomic stabilization : surely it would be a necessary condition for sustainable development, but would not be a sufficient condition on its own. In addition to economic stabilization at this time, Niger's economy is in need of an engine of growth. It can not be found easily without an environment in which a market mechanism works smoothly, such as, enough entrepreneurship and appropriate circulation of market information, which, in the meantime, the Nigerien economy can not afford. In this regard, experienced and specific technical advice from international organizations, such as suggestions on the potential engine of growth is essential. It could supplement the area where a market mechanism does not work well. Having said that, the basic question can now be raised regarding the role of the Fund : whether it should be strictly contained within policy recommendations for macroeconomic stabilization or extended further. From the view point of a least developed country like Niger, I am quite sure that it needs further assistance beyond macro economic stabilization, such as policy recommendations for a possible engine of growth. Traditionally, this kind of role has been taken by the World Bank. But such policy recommendations beyond macroeconomic stabilization could contribute to a long-term balance of payment position or fiscal position of the relevant country, especially in case where the country concerned is small and least developed. Therefore, I believe that close cooperation between the Fund and World Bank staff is very important in this case. Our two organizations have already have collaboration in the area of financial sector reform policies. I think we need to extend our collaboration efforts to overall development strategy, for the cases of the least developed countries, such as Niger. The staff''s comments on this matter would be appreciated.

On the macro level, I would like to point out that the speed of improvement in the real sector seems too late. For example, their targets in investment and domestic savings ratio by 2000 are 13 percent and 8 percent respectively. With such a low investment ratio, the take-off stage in economic development of Niger cannot be reached by 2000. In this regard, I would like to emphasize the importance of pushing up investment and domestic savings ratios even higher. In order to reach the take-off stage, and I am now reflecting on my own country's experiences in the 1950s and 1960s, the investment ratio should be at least 15 percent. This elevated investment should go to the engine of growth sector. Without such an impact in the early stages, it would be very difficult to get into the take-off. Of course domestic savings cannot finance all of the investment projects. It tends to increase as incomes increase. Therefore, in Niger's case where domestic entrepreneurship is not enough because of the small size of its population, foreign capital with entrepreneurship is essential.

Inviting foreign direct investment is not an easy task; it tends to move for its own sake. It is widely accepted that there are three patterns of foreign direct investment according to its orientation. Namely, cost-oriented, domestic market oriented, and resource-oriented foreign direct investments. In the case of Niger, since it cannot provide a large domestic market, resource-oriented or export-oriented foreign direct investment could be more plausible. I would appreciate the staff's comments on these matters.

In addition, I believe that unprecedented efforts to increase the domestic savings ratio are essential to support a higher investment ratio, especially in the case of Niger where foreign donor contributions tend to stagnate. I would appreciate the staff's comments on this matter also.

Finally, with these few remarks, I wish the Nigerien authorities well in their efforts and success in entering a new development era in the near future.

Mr. Fujii made the following statement:

I am concerned that Niger was unable to achieve the targeted economic performance in 1996 in the areas of real GDP growth and annual inflation. The budget balance in 1996 improved more than was targeted. This was partly because the authorities succeeded in cutting the wage bill by 33 percent, and at the same time, partly because foreign-financed capital outlays were greatly reduced, which is not a favorable development in terms of the medium-term growth. In addition, in March 1997 the overall balance of payment deficit exceeded the program target because of the increase in wage and salary payments as well as the recovery of foreign-financed capital outlays. In this regard, the budgetary position still remains fragile.

On the external sector, it is a welcome development that the current account balance in 1996 improved partly because of the fall in capital goods imports financed by foreign aid. However, foreign-financed imports of capital goods is expected to increase in 1997, and, therefore, the current account deficit will increase. In addition, Niger's exports depend largely on uranium, the export price of which is tending to decline. As to services, because Niger must pay freight and insurance fees for trade there is a structural deficit. In this respect, it appears that it will be difficult to improve the current account balance in the medium term.

I am concerned that the authorities were not able to achieve two benchmarks in March 1997. On the benchmark on the reduction of external payments arrears, the staff explains that its nonobservance is attributable to delays in securing the needed technical or financial assistance. However, these delays reflected uncertainties about governance and the loss of confidence of the international community. It is critical to restore the confidence of the international community and maintain external assistance. The authorities depend heavily on such assistance to finance the balance of payments deficits and investment projects as well as to reduce external arrears. To this end, the authorities need to address not only governance issues, but also to improve relations with external creditors.

On the benchmark on the wage bill, the staff explains that it was not observed because of delays in implementing the new civil service salary grid. Such delays seem to indicate insufficient commitment by the authorities to the adjustment program.

Thus, although the first annual ESAF arrangement was implemented, economic performance has been unsatisfactory, the external position remains vulnerable, and there is seemingly insufficient commitment to the adjustment program. In these respects, I have reservations about supporting the second annual arrangement. The authorities should make every effort to create a good track record by faithfully implementing a comprehensive adjustment program. On fiscal policy, revenue should not only be increased by broadening the tax base and improving the tax administration, but also by reducing expenditures through the implementation of civil service reform. On structural reform, privatization of public enterprises needs to be accelerated, and at the same time, a well-designed safety net program needs to be implemented in order to mitigate the impact of reform. Moreover, it is expected that the authorities will address the governance issues and reduce their external arrears successfully so as to restore the confidence of the international community. Assuming that the authorities make a firm commitment to implement these policies, I support the proposed decision.

With these remarks, I wish the authorities every success.

Mr. Disanayaka made the following statement:

Niger's adjustment efforts that were resumed in the latter half of 1995 appear to have gathered momentum under the first year of the ESAF program—1996/97, as is evidenced by the continued good growth performance, decline in inflation and strong fiscal adjustment. Most of the performance criteria for end-September 1996 and quarterly benchmarks for March 1997, under the program, have been met, despite a difficult domestic and external environment. Among the noteworthy achievements on the fiscal front are the increase of budgetary revenue by nearly ½ of the GDP and a reduction of the wages and salaries bill by nearly ⅓. On the structural front significant steps were taken to improve tax administration and reform civil service, a new salary grid for civil servants was formulated, a strategy for privatization was developed and a privatization agency was established. These are indeed very significant steps and we commend the authorities for their efforts.

The program worked out for 1997/98, for which support under a second year ESAF arrangement is now sought by the authorities, is equally strong. It is designed to build upon the progress already made in the last two years (including the first year under the ESAF program). The main macro objectives of this program are to attain a growth target of 4½ percent, reduce inflation to 3 percent and external current account deficit to 11 percent in 1997 and 10.5 percent in 1998. The second year program has been developed against the background of an updated three-year medium-term strategy (1997–2000) having similar if not a bit more ambitious targets. PFP

(EBS/97/85) describes in detail this medium-term strategy. In our view, the program worked out for the second year, appearing as Annex in Appendix II, page 52 of the staff report is well conceived and carefully crafted.

We would encourage the authorities to implement the performance criteria and benchmarks as specified in this program with the same determination and courage as was displayed under the first year. In particular we wish to emphasize, like the staff, the following areas for priority attention of the authorities in the coming year: (1) further strengthening of the tax collection by such measures as transfer of property tax to the tax department and strictly limiting import duty exemptions; (2) avoiding further accumulation of arrears in domestic and external payments through stringent expenditure control and efficient revenue collection; (3) launching a comprehensive civil service reform program once the census of civil servants is completed and early implementation of the new salary grid for the civil service; (4) taking early steps to strengthen the banking system as recommended by the regional banking commission; (5) accelerating the process of privatization of those ventures that do not require external financing and technical support, such as Olani, SNC and the storage facilities of SONIDEP; (6) developing a well targeted safety net to cushion not only those most vulnerable from the effects of strong adjustment but also those who would be loosing jobs in the process. Adequate compensation has to be found for the latter category, not the least for winning broader support for the restructuring program itself; (7) diverting more resources to social sectors such as health and education and for strengthening rural agricultural infrastructure and environ-mental protection. These measures are of crucial importance in view of the poor social indicators of the country and wide-spread poverty.

We recognize that some of these programs cannot be completed within a short period of one year, as they have a medium-term perspective. Nevertheless it is our hope that the second year ESAF arrangement, would consolidate the strong reform efforts in these areas by pushing them further. These efforts would certainly be bolstered by the efforts of the World Bank and other multilaterals in the structural area.

Finally we agree with the staff that however strong the will and commitment of the Nigerien authorities would be in the pushing forward the reform agenda, its strength cannot be sustained too long without substantial external assistance. In this connection we note that Niger has made significant progress toward normalizing its relations with external creditors. We also appreciate the debt relief already granted by Paris Club creditors to Niger in 1996 and hope that the ongoing negotiations the country is conducting with other creditors too would result in an appreciable level of debt relief. We would urge the donor community to enhance their support to the country at this juncture to continue with its bold reform efforts.

We would also urge the Nigerien authorities to explore all possible ways of broadening the social consensus that is so very essential for maintaining the momentum of their restructuring program.

With these remarks we support the authorities' request for the second annual arrangement and wish the authorities all success in their efforts.

Mr. Barro Chambrier commented that he disagreed with Mr. Fujii that the delay in implementing the new civil service salary grid reflected insufficient commitment by the authorities to the program. As recently as 1996, it had been unclear whether or not the authorities should introduce such a grid in the first place. Despite the difficult domestic and external environment, the authorities had made good progress in implementing the adjustment program since mid-1995; they had not hesitated to take difficult and unpopular measures—such as regarding salary arrears to civil servants—to ensure program implementation. The authorities recognized that the wage bill was a large portion of the budget, and would make every effort to reduce it to a sustainable level. While one could, of course, focus on relatively less successful aspects of the program, the fact remained that growth had increased, inflation decreased, and civil service reform had begun under the program. The authorities regretted that, despite their courageous adjustment efforts, they had not received the full support of the international community.

Mr. Loevinger recalled that, in his earlier statement, Mr. Barro Chambrier had referred to a difficult external and domestic environment in 1996. Yet external grants and loans to the government had been larger than programmed in 1996, and the difficult domestic environment had stemmed largely from the authorities' own actions.

Mr. Barro Chambrier remarked that, in fact, less assistance had been received than had been projected. Furthermore, the availability of technical assistance was also important, as it would affect, for example, the establishment of the new civil service salary grid. The difficult domestic environment in Niger had affected the program; in that context, he recalled the comments of Ms. Lissakers at a previous discussion on the possibilities of closing the financing gap. Niger had made substantial adjustments in difficult conditions, had realized that it was important to make further progress, and wished to normalize relations with creditors.

Mr. Berrihun made the following statement:

Despite difficult circumstances, Niger's economic progress since mid-1995 has been encouraging, as evidenced by strong growth, a fall in the rate of inflation, a reduction in financial imbalances, and significant progress in the area of structural reforms. In this context, I welcome the authorities' observance of most quantitative and structural benchmarks under the program—the few exceptions being those affected largely by a shortfall in external assistance.

As the staff has rightly indicated, the authorities' great determination to implement the program has been the critical factor in the achievement of these results. Yet Niger has arduous tasks ahead in its efforts to develop its potential and to raise its living standards. The authorities should therefore persevere with their efforts to further reduce the fiscal and external imbalance in the short run and to change macroeconomic and sectoral policies to facilitate the achievement of sustainable development in the long run. Toward this end, the authorities' macroeconomic objectives for the period 1997–2000, as well as the program for 1997/98, offer much promise.

The medium-term strategy is rightly focused on broad-based rural development and improvements in the productivity of traditional agriculture; the promotion of nontraditional export crops; expansion of the livestock sector; development of small-scale irrigation; and environmental protection.

The rural sector remains central to the government's growth and poverty alleviations efforts. This is because poverty is heavily concentrated in the rural areas, with a large segment of the population deriving its principal source of income from activities in this sector.

To reduce poverty significantly, economic growth will need to be sustained at a rate surpassing that of population growth. This will call for higher investment than has been the case so far. But such investment cannot be financed by Niger alone, because there are constraints on raising domestic savings in a country such as Niger, in which real per capita income is very low. In such a setting, the scope for raising the already-low ratio of revenues to GDP—and thereby enhancing government savings—is also limited. This difficulty is compounded by the fact that there is only limited scope to cut expenditures from their current level, which is already far too low to meet the pressing needs of the population. Dependence on outside help is as great as ever, in terms of both new flows and generous debt relief, as Niger's key debt and debt-service ratios remain substantially above the thresholds used as eligibility criteria under the HIPC Initiative.

The social indicators clearly show that there is an urgent need for reorienting spending toward social services. A well-developed human resource base could only be made possible by heavy investment in education and health services. Such investment can also play a critical role in Niger's effort to address the problem of poverty. I therefore welcome the authorities' commitment to allocate more resources to these sectors in the future. I wish the authorities success in their difficult endeavors and support the proposed decision.

Mr. Santos made the following statement:

Despite some adjustment efforts thus far, Niger's economic and financial situation remains very fragile. In 1996, the growth and inflation targets under the ESAF-supported program were missed, and many of the benchmarks and performance criteria for end-December 1996 and March 1997 were not met—even after substantial revisions to take into consideration the shortfall in external financial assistance. Moreover, it is worth noting that, to some extent, the shortfall in external technical and financial assistance reflects problems of governance, which have caused some hesitation among creditors and donors to support the program.

The uncertainties about the amount of external aid available underscore the need for caution and realism in setting program targets—a concern that seems to have been taken into consideration in the design of the current program. My chair is especially gratified that priority will be given in the privatization program to actions that can be implemented without delay, and on the basis of available financial and technical resources. Such a pragmatic approach to programming should be followed whenever possible, rather than one of in which increasingly ambitious goals are set, but not met. Despite the adoption of more realistic assumptions under the program, my chair still feels that there are significant risks to the program, as full implementation of it remains highly sensitive to the level of donor support and the timely disbursement of external assistance.

That being said, I wish to make two brief points on inflation and the fiscal situation. Contrary to the experience of other CFA franc countries, inflation has not fallen to the levels prevailing before the devaluation of the CFA franc (CFAF) in early 1994. This has further eroded the competitiveness gained by the devaluation of the CFAF. In 1996, it is estimated that the CFAF appreciated by some 3.3 percent in real effective terms. This problem is especially pertinent in the case of Niger, given the substantial deterioration in the terms of trade in 1996, which is projected to continue in 1997, and the substantial external imbalance. It is a cause for concern that the external current account deficit as a percentage of GDP, and excluding official transfers, is higher it was before the devaluation of the CFAF.

Despite continuing efforts to improve tax and customs administration, to broaden the tax base, and to reduce tax fraud, budgetary revenues accounted for the equivalent of only 7.8 percent of GDP in 1996. This level is below the program target—which is very low, even by African standards—and indicates that much needs still needs to be done to increase fiscal revenues.

Mr. Fayolle made the following statement:

I would like first to commend the Nigerien authorities for the encouraging performance achieved under the first annual arrangement in difficult circumstances. I am particularly impressed by the further reduction in the level of inflation and the success achieved so far in reducing the budget deficit.

As Mr. Kwon rightly recalled, Niger is one of the poorest countries in the world, and should be encouraged to pursue on the way of macroeconomic adjustment and structural reforms, which are key to increase growth potential, even if I agree with Mr. Barro Chambrier that this way is not a very easy one. Priorities are to accelerate structural reforms, to continue efforts in order to increase revenue, and to regain full support from donors and creditors.

Since I am in broad agreement with the staff appraisal, I would like to make only a few comments.

On fiscal policy, one can be impressed by the authorities' effort to mobilize government revenue and contain expenditures. Given Niger's weak domestic resource mobilization, setting up ambitious objectives is understandable. But, even if I welcome the measures taken in order to improve tax structure and tax administration, I still think that 1997 budget projections might be rather optimistic, as is also the revenue objective for 1998.

Revenue is expected to rise by about three points of GDP between 1996 and 1998. Even if the revenue target for 1997 may appear modest and remains below 10 percent of GDP, this would include some risk, since real GDP growth remains moderate and domestic industrial performance vulnerable to external shocks.

Expenditures, therefore, have to remain strictly under control, especially as far as wages are concerned. Thus I also welcome the contingency plan referred to in the report. I share the view expressed by other Directors that the authorities should implement, timely, the ambitious program on structural reforms, including the civil service reform, and I welcome the commitment by the authorities in this regard, as reiterated by Mr. Barro Chambrier in his buff statement. I also hope that the resumption of foreign assistance will continue, especially because there is a worrisome trend in gross domestic investment.

In conclusion, I think the main message we should send to the Nigerian authorities should be to encourage them to continue on this demanding path. This will pave the way to consider, given the high level of Niger's debt burden, in due time, Niger's eligibility under the HIPC Initiative.

The staff representative from the African Department commented that the Fund and the World Bank had been working together for some time on accelerating growth in Niger. The staff had tried to focus on how the authorities could create an enabling environment for the private sector, to allow it to assume a larger role in the economy. In cooperation with the Bank, the staff had been assisting the authorities in liberalizing the regulatory framework, and in privatizing the energy, water, and telecommunications utilities. The Bank had been working on improving performance in the agricultural sector. Despite those initiatives, one had to keep in mind specific constraints on growth in Niger, chiefly that the country was in the Sahel region and was thus subject to occasional droughts. Niger, alone, could not do much to contain droughts although the authorities might over time work to create an irrigation system to mitigate their impact. In any event, despite the difficulties caused by recurring droughts, the authorities had been working hard to implement prudent macroeconomic policies, and inflation had fallen to about 3.6 percent by the end of 1996—although imports of food aid had also contributed to that fall.

The program aimed at increasing the ratios of savings and investment to GDP under the macroeconomic framework to the year 2000, as described in the policy framework paper, the staff representative noted. In a country such as Niger, increased domestic savings would have to come first from increased government savings, which the authorities could influence directly through their revenue and expenditure policies. The program made a substantial effort at increasing government savings—so much so that one Director had felt that the targeted ratio of fiscal revenues to GDP for 1997 and 1998 was ambitious. That being said, growth and development in Niger required increased investment and increased domestic savings to finance some of the investment, or, at the very least, to provide counterpart funds for foreign-financed projects.

External assistance had fallen short of the original program projections, as indicated in Box 1, the staff representative stated. If one had wished to use Table 3 to compare grants and loans projected versus grants and loans received, the large financing gap indicated in that table

(CFAF 74 billion) would have had to have been broken down into grants, loans, and debt relief; however, the staff had not had a chance to do so before submitting its paper to the Board. While Table 3—on financial operations of the central government—should be read in conjunction with Box 1—on performance criteria and benchmarks under the 1996/97 program, they were not strictly comparable. Beside the shortfall in nonproject external assistance, indicated at the bottom of Box 1, the staff could have added another line indicating the shortfall between expected debt relief and actual debt relief. Those combined shortfalls accounted for nearly all of the discrepancy between the external arrears that the authorities had been expected to repay, and those that they had actually repaid.

The program's performance criteria and benchmarks, including the benchmarks on domestic and external arrears, had not been revised to reflect the shortfall in donor assistance (shown at the bottom of Box 1), the staff representative clarified. Rather, the revisions had been made simply to take account of further information obtained from the new authorities on the program outcome in March 1996, which had required revisions to the program performance criteria and benchmarks (as noted in footnote 1 to Box 1) prior to consideration by the Executive Board in June 1996.

Mr. Loevinger commented that, to his understanding, Table 3 appeared to indicate that external creditors had borne the brunt of the shortfall in external assistance. The difference between the line on total external financing grants and loans amounted to about CFAF 26 billion, which was about equal to the authorities' further accumulation of arrears.

Mr. Loevinger then made the following statement:

> While Niger has broadly met the program's fiscal targets, much of the adjustment achieved has relied far too much on unsustainable stop-gap measures. So far, the composition of fiscal adjustment has not been consistent with the authorities' stated objective of accelerating growth and achieving a durable reduction in poverty. The government has relied too heavily on compressing public sector wages, and cutting public investment and social safety net expenditures. We are in fact pleased to see the second year ESAF provide for increases in the latter two areas.
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> One reason why the government has had to rely on compressing public wages is that there continue to be slippages in reducing the public sector workforce. While it seems that the authorities are finally starting to make progress to reduce public sector workforce, we would be interested in hearing staff's views on the voluntary departure program. At very roughly USD4000, or almost 20 times per capita GDP, average budgetary cost per departure seems generous. How does this compare with programs in other countries?
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> As this chair has stated before, we are concerned to see that much of the planned increase in taxes next year will come from higher trade taxes, particularly on exports. The proposed 5 percent "statistical" tax on exports seems far in excess of what is needed for statistical purposes. As Mr. Barro Chambrier noted in his statement, Niger's debt burden is high, even if it is not high enough at this point to qualify for HIPC. In considering a country's capacity to service its debt, and its eligibility for HPIC eligibility, we look at the debt and debt service to export ratios. It is important that we pay

close attention not only to the numerator, but also take a hard look at what countries are doing to increase the denominator of these ratios. Export taxes seem like a step in the wrong direction, particularly for a country as heavily dependent as Niger on the export of a single commodity. We hope that this will be "harmonized" with other WEAMU countries down to a significantly reduced level next year.

We noted that staff attributed part of last year's decline in real money balances to continued concerns about the health of the banking system. In the Memorandum of Economic and Financial Policies, the authorities commit to restructure several financial weak government-owned financial institutions and open up their capital to private investment, as appropriate. Could either the staff or Mr. Barro Chambrier comment on what factors would guide the authorities in determining whether opening up these banks' capital would be appropriate?

It seems there is a change in strategy in the privatization program. While several speakers have talked about the need to accelerate privatization, our concern is that the original commitments in the program are not being met. It now seems that the authorities will be focussing on the easiest, and not necessarily the most important privatizations. While this is understandable, given domestic opposition, it would be useful if staff would comment how the authorities' commitments in this area compare to their original ESAF commitments. Are we agreeing to a less ambitious program without any reduction in access?

Finally, as staff notes, Niger is expected to continue to run large balance of payments financing gaps. We agree with staff that the authorities need to do more to address donors' concerns about governance, particularly finding some accommodation with opposition parties. This is important not only to secure donor assistance, but also to safeguard macroeconomic stability. We suggest the authorities look at developments in Kenya to see the risk to macroeconomic stability of ignoring these issues.

Mr. Nemli made the following statement:

The adjustment efforts of Niger's authorities are being rewarded by a resumption of growth, a sharp reduction of the fiscal deficit, and declining inflation. Niger has also made significant progress with the implementation of structural reforms. Nonetheless, the authorities still have a long way to go. Niger is a very poor country whose social indicators are among the weakest in the world, and the successes described above must not give rise to complacency.

With its high rate of population growth, Niger needs a high rate of sustainable growth for its per capita income to increase. But the low level of national savings, no more than 3.8 percent of GDP in 1996, and the correspondingly low level of investment, rules out a satisfactory growth rate. In this situation the authorities should focus primarily on increasing public sector savings by improving the government's fiscal position, and on increasing private savings by improving the general economic and political environment.

It will take strong and determined action on both the revenue and expenditure fronts to improving the fiscal position. Niger's tax revenues are very low by any standard. Essential steps will be broadening the tax base and improving the efficiency of the tax collecting agencies. Other crucial actions are the timely implementation of the specific revenue measures included in the 1997 Budget Law, stricter enforcement of existing tax laws, and reducing tax fraud.

On the expenditure side, the staff has rightly warned against allowing wages and salaries from crowding out essential spending, especially on education, health and other social services. Reformation of civil service is overdue and urgently needed. One would add that attention should be given to improving the composition of expenditures generally. Unfortunately the absence of data indicating where budgetary resources were spent make it impossible to assess the situation clearly. However, given the urgent needs of the society, the authorities' intention to increase the budgetary allocation for the health and education sectors by 10 percent per annum in real terms seems appropriate. I admit that I am confused about the budgetary allocation for scholarships, and would appreciate some further clarification from the staff. The authorities' plan to limit scholarship spending by controlling irregularities and establishing a rigorous selection process is welcome. But I was surprised to see that the budgetary appropriation for scholarships has been increased almost threefold, from 1.6 billion CFA francs during the 1996/97 program period to 4.3 billion during the 1997/98 program period. I wonder whether the irregularities have already been sufficiently brought under control to ensure that this greatly increased budgetary allocation is not misused. But even if all past irregularities in this area have been completely eliminated, it still seems doubtful that such a large allocation can be justifiable in terms of Niger's spending priorities.

The medium-term balance of payments projections show clearly that Niger will continue to depend heavily on concessional external assistance and grants. Although official transfers are steadily declining, they could still be as high as 4.8 percent of GDP in 2005. It cannot be overstated how important it is for Niger to addressing donor concerns. Not only external viability, but other several crucial elements of the program such as making the severance payments related to privatization and financing the food aid program depend on the continuation of external assistance. The authorities must therefore do their best to restore the donors' confidence by urgently and efficiently addressing governance concerns and fostering a political consensus.

Popular support for the stabilization and reform effort is crucial to the sustainability of the reform process. The strong opposition of the unions to the privatization program is a source of serious concern. The authorities must pay appropriate attention to the social aspects of the program and make every effort to improve their dialogue with all social partners. Improving governance and developing a well-designed safety net, food aid, and a program for creating labor-intensive jobs can be important measures for increasing popular support for the program.

Before ending, I need to stress the urgency of curbing Niger's high rate of population growth in the medium to long term. Effective family planning initiatives are needed to alleviate the pressures of overpopulation on Niger's scarce resources and social services.

Niger's authorities have achieved important improvements in macroeconomic stabilization and structural reforms under very difficult internal and external conditions. Their commitment to prudent policies and to addressing donor's concerns deserves support from external concessional assistance.

I support the proposed decision and wish every success to the authorities.

Mr. Borpujari made the following statement:

It is encouraging that Niger's adjustment and reform effort has remained broadly on track despite a difficult domestic and external environment. The recovery, however, is yet to take a firm hold. Indeed, output growth and reduction of inflation fell short of program goals last year. Given Mr. Barro Chambrier's statement on the authorities' policy commitment, I feel reassured that a reversal of the unfavorable trends is on the way.

I broadly agree with the staff's recommendations and will only have brief remarks for emphasis.

The continued priority for fiscal consolidation is well-placed. The steps to expand the tax base and improve tax administration are welcome in view of the relatively low ratio of revenues to GDP. The authorities should, however, consider an early reduction of the growing dependence on taxation of international trade. On the spending side, both the curb on nonpriority current spending and the near doubling of capital spending are welcome. Here, avoidance of any slippages in implementing the civil service reform goals is critical. I also urge strict adherence to the commitments on clearance of domestic and external arrears and avoidance of new arrears.

Regarding structural policies, avoidance of any further delays in privatization and public enterprise reform is crucial. Earmarking of privatization receipts for redundancy payments should help ease the difficult challenges in this area. Also welcome is the authorities' renewed resolve to establish an efficient legal and judicial framework for the financial sector.

With these remarks, I support the proposed decision and wish the authorities success in meeting the difficult challenges ahead.

Ms. Lai made the following statement:

> It is encouraging that Niger has made progress in its adjustment program in spite of the difficult conditions. As most of the performance criteria were met except for some delays, I broadly agree with the thrust of the staff appraisal and would like to support the proposed decisions. Therefore, I would give emphasis to only two areas: fiscal policy and financial sector. Notwithstanding the authorities' achievements in these areas, further progress has to be made to strengthen the economy and foster faster growth.
>
> The reduction of the fiscal deficit is an important step in raising the level of savings which would in turn mobilize resources for investment. We welcome the authorities' aim to reduce the overall fiscal deficit, and to this end, revenue mobilization measures should be implemented in a timely manner and expenditure should be well-controlled.
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> We share the staff's concern about the health of the banking sector, given the high proportion of nonperforming loans. Further efforts have to be made to improve the soundness and efficiency of the banks as financial intermediation plays an important role in facilitating economic growth.
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> With these remarks, we wish them every success in their challenging endeavors.

Mr. Rouai said that he welcomed and supported the second annual arrangement under the ESAF, and joined other speakers in commending the authorities for the progress achieved. He agreed with the staff's appraisal, particularly in the areas of fiscal consolidation, banking restructuring, and privatization. Regarding the staff's reference to the preparation of a debt sustainability analysis on a loan-by-loan basis, he wondered whether it would differ from the approach followed for other countries. He encouraged the authorities to persevere and widen the scope of their adjustment and reform program in order to be in a position to benefit in due time from support under the HIPC Initiative.

Mr. Schmalzriedt remarked that he fully shared the concerns expressed by several speakers, especially by Mr. Fujii, regarding the repeated nonobservance of the program benchmarks for the reduction of domestic and external arrears. The slippages in that area could not be attributed solely to lack of technical and financial assistance; it was up to the authorities mainly to create the necessary prerequisites for external assistance by pursuing appropriate policies.

Mr. Phan said that he supported the proposed decision, but would mention one issue for the sake of emphasis. As Niger was especially underdeveloped in terms of social indicators, the authorities needed to pay much more attention to improving public health and education and to alleviating poverty, particularly if they were to be able to sustain economic development.

The staff representative from the African Department commented that the authorities were well aware of the need to increase exports by ensuring that there were no export impediments. They were working with other WAEMU states to harmonize their tariff system by early 1998 in a regional customs union, which would likely involve reductions in individual countries' tariffs, and in the statistical tax. Indeed, the current thinking was that the statistical tax should be reduced to about 1 percent in all member countries. The authorities had levied the latter because they had been unable to tax the wages of locally hired people working for an international organization in the capital, Niamey, even though those people did not have diplomatic status. In Niger's circumstances, the tax was understandable, given the difficult task of mobilizing revenues. In any event, they would probably reassess the rate of the statistical tax in early 1998.

Wherever needed, the government should relinquish part of its equity holdings in banks, in line with the recommendations of the regional banking commission, the staff representative clarified. Not all banks had to open up their capital to the private sector, because three of the five banks currently operating were fully private. The wording in the staff paper was intended to refer to the need for the government to open up banks' capital to the private sector "wherever needed"—not "as needed." Indeed, it was the regional banking commission—not the authorities, strictly speaking—that assessed the condition of banks in Niger and made recommendations. For some of the banks, it had recommended cost-cutting administrative reforms, and for others, it had recommended the opening of their capital to the private sector.

It would not have been helpful if the authorities had indicated that they wished to privatize NIGELEC and all other major public entities and then failed to deliver on their intention because of lack of required technical and financial assistance to do so—the latter for severance payments—the staff representative considered. Rather than aiming too high, they had decided to privatize as many entities as they could with the existing technical and financial resources. Under the incremental approach to privatization, if the sales of OLANI, SNC, and Abattoirs Niamey were successful, the resulting privatization proceeds would facilitate the sale of larger entities, such NIGELEC and SONIDEP. The World Bank had been working with the authorities on the privatization program.

The authorities had spent CFAF 4.5 billion on scholarships in Niamey in 1995, but only CFAF 2.2 billion in 1996, which had been an atypical year given the substantial adjustments initiated then, the staff representative indicated. They planned to spend CFAF 3.8 billion in 1997, before reducing that amount to a constant CFAF 3.5 billion thereafter. While the authorities were trying to be as prudent as possible in granting scholarships, they faced the reality that many youth could not attend school without some government assistance. The World Bank had been working with the authorities on education reform.

Although he could not comment on the average cost of voluntary departure schemes in the rest of West Africa, the staff representative said, the authorities were committed to controlling the wage bill. One should take into account the fact that, over the medium- to long-terms, budgetary savings would be achieved not only in wages per se, but also in housing allowances and other benefits, which were a part of the total wage bill. Thus, although the cost of the voluntary departure scheme might appear to be high at present, over the longer term, it might well result in net savings because of reduced nonwage staffing costs.

The staff had conducted a debt sustainability analysis in 1996 when the Board had approved a three-year ESAF arrangement, based on a broad distribution of Niger's debt by creditors, the staff representative recalled. To assess accurately whether or not Niger was close to or exceeded the eligibility criteria of the HIPC Initiative, the staff would conduct a loan-by-loan, currency-specific analysis that would take into account each of Niger's outstanding loans, thereby ensuring accurate debt sustainability projections. The resulting analysis would be far more refined than the staff's initial effort in 1996.

The staff representative from the World Bank commented that the Bank staff was preparing a country assistance strategy paper, which presented the results of the Bank's discussions with the government and civil society on Niger's economic prospects. Clearly, two of the potential sources of growth, agriculture and mining, might not be easy to support. The prospects of the mining and petroleum sectors remained uncertain; it would take a few more years before the extent of gold and petroleum resources would become apparent. Agricultural potential was severely limited owing to harsh environmental conditions. For those reasons, the Bank staff had stressed the importance of the authorities' supporting a conducive environment for private sector and human resource development as preconditions for any economic takeoff in Niger. That being said, the development process in Niger would be a long one, requiring sustained support from donors.

Other countries in the region had had much smaller redundancy packages, providing redundant staff with support equivalent to about 8–10 months of salary, rather than up to three years in the case of Niger, the staff representative added. The government was still assessing the tradeoff between the need to provide support to encourage departures, which would be voluntary, and the financial costs of doing so.

The World Bank and the authorities were emphasizing privatization of the three smallest enterprises and SONIDEP, the petroleum importing company, the staff representative pointed out. While efforts to privatize other, larger enterprises, such as public utilities, had not stopped—pre-qualification documents, for example, had been issued for the consulting companies that would prepare the privatizations—those transactions would take longer than one year to achieve. For instance, the staff had estimated that it would take 15 months, until January 1998, for the water company to be privatized. If that target and others could be met, Niger would have achieved one of the faster privatizations in the region. The privatization program thus continued to be comparatively ambitious.

Mr. Barro Chambrier said that his authorities had asked him to reassure the Board of their strong commitment to pursue macroeconomic stabilization and structural reform. They were making every effort to improve the social and political climate in Niger, including creating a political consensus, and were taking steps to improve transparency. They recognized that it was up to them to create the necessary conditions to boost the provision of external assistance, and hoped that their efforts would bear fruit over the forthcoming months—especially as the provision of necessary concessional financial assistance, including debt relief, could greatly reduce the burden of adjustment and help to accelerate growth. That being said, he wished to reiterate that the shortfalls in externally financed outlays had severely constrained the authorities' efforts to make faster progress toward financial sustainability, and had made them unable to meet the program benchmark on arrears. The authorities firmly intended to eliminate by end-March 1998 all domestic payments arrears that had been identified and verified at end-March 1997. They also attached high priority to normalizing relations with external creditors, and would make major efforts to reduce the accumulated external payments arrears by the end of the year.

The authorities agreed that an efficient banking system was a prerequisite for the development of a strong private sector and a well-functioning economy, Mr. Barro Chambrier stated. They had already done much to improve the financial position of the Banque Commerciale du Niger, although the financial situation of three small banks remained difficult. With the assistance of the regional banking commission, the authorities would step up both their efforts to restructure those banks and their efforts at loan recovery. Regarding the important question of the conditions under which bank capital should be opened up to the private sector, it would be important to restructure the banking system first, so that banks would have sound portfolios that would be attractive to private investors.

While the authorities intended to accelerate their privatization efforts, one had to recognize that a substantial share of the labor force was represented in those enterprises and that it would be necessary to put into place a social safety net to alleviate the burden of unemployment resulting from privatization, Mr. Barro Chambrier observed.

He would convey to the authorities Directors' concerns about spending on scholarships, Mr. Barro Chambrier indicated. While budgetary efficiency obviously needed to be improved in that area, the authorities recognized that irregularities needed to be addressed through the use of a rigorous selection process to ensure that only the most deserving students received support. They would reinforce their control of the budgetary process in the area of scholarships.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. Policy implementation and economic developments under the program supported by the first annual arrangement under the Enhanced Structural Adjustment Facility were considered encouraging. In particular, the budgetary outturn in 1996/97 had been in line with expectations, and the program of structural reform remained broadly on track in spite of delays encountered in some areas. Most quantitative and structural benchmarks for end-December 1996 and end-March 1997 had been observed, with the exception of the benchmarks on the wage bill, the completion of the civil service census, and the reduction of external and domestic arrears.

Directors observed that, after a number of years of poor macro-economic performance, economic growth appeared to have resumed, while inflation continued to decline. However, significant further actions were needed to build on those improvements to strengthen prospects for growth and to achieve the desired increases in saving and investment. In that regard, Directors underscored the importance of pressing ahead with the structural reform program without delay, particularly in the areas of civil service and public enterprise reform and privatization. They urged the authorities to implement strictly the envisaged program measures in order to lay the basis for private sector-led growth, and to restore donors' confidence, and reduce the serious level of poverty.

Directors stressed the continued fragility of Niger's economic and financial situation, which made strict adherence to the adjustment program indispensable. They emphasized the importance of determined pursuit of fiscal consolidation. They urged the authorities to continue implementing in a timely manner all revenue measures envisaged under the program for broadening the tax base and strengthening tax administration, while maintaining restraint in current spending. With regard to the latter, full implementation of the new salary scale and completion of the census of government employees were viewed as essential to securing adequate control over government expenditure. At the same time, Directors noted Niger's extremely weak social indicators and stressed the need to reorient expenditures to increase spending on education and health.

Directors emphasized the importance of strengthening the viability of the financial sector. They expressed the view that the strict adherence to sound banking practices and the full implementation of the regional banking commission recommendations, particularly those pertaining to provisioning for nonperforming loans and loan recovery measures, were key to the strengthening of the banking system and of financial deepening and intermediation in Niger.

Directors observed that Niger's medium-term balance of payments outlook remained fragile, and vulnerable to external shocks; noting the importance of meeting in a timely fashion the country's debt-service obligations, they stressed the need to continue to pursue a prudent debt policy that relied on grants and highly concessional loans. Directors also stressed the need for the authorities to make every effort to secure donor support, which was critical for the full implementation of the reform program. That would require, inter alia, maintaining normal relations with creditors through timely discharge of external debt-service obligations and addressing the governance issues that had led to the reduced availability of external assistance during 1996. It was noted that improvements in governance were also essential for ensuring macroeconomic stability.

Directors urged the authorities to improve further the statistical database, particularly in the area of the national accounts, monetary and credit indicators, the balance of payments, and monitoring of the public investment program.

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

The Executive Board took the following decision:

1. The government of Niger has requested the second annual arrangement under the Enhanced Structural Adjustment Facility.

2. The Fund has appraised the progress of Niger in implementing economic policies and achieving the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper set forth in EBD/97/85.

3. The Fund approves the second annual arrangement set forth in EBS/97/131, Supplement 1. (EBS/97/131, 7/14/97)

Decision No. 11550-(97/78), adopted
July 28, 1997

5. SENEGAL—1997 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY—REVIEW UNDER THIRD ANNUAL ARRANGEMENT, AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Senegal and the midterm review under the third annual arrangement for Senegal under the Enhanced Structural Adjustment Facility (ESAF) (EBS/97/130, 7/14/97). They also had before them a background paper on selected issues in Senegal and a statistical appendix (SM/97/189, 7/14/97).

Mr. Barro Chambrier, speaking on behalf of Mr. Yao, made the following statement:

> There is broad agreement between my Senegalese authorities and the staff on the analysis of Senegal's recent macroeconomic performance, as well as the appropriate policy mix and structural measures that will be required in order to achieve the objectives of the country's medium-term adjustment and reform strategy. The implementation of this strategy, in the framework of the third annual ESAF arrangement, has been successful. The quantitative performance criteria and benchmarks for end-December 1996 and end-March 1997 were observed. The large majority of structural performance criteria and benchmarks for end-March 1997 were also implemented, though with some delays in a number of cases. As indicated by the staff, my authorities are requesting a waiver for one structural performance criterion which was observed with some delay.
>
> Senegal's overall economic performance in 1996 has been encouraging, with real GDP continuing to pick up, the rate of inflation declining and the external current account deficit, excluding official transfers, narrowing to a more sustainable level in 1996. This encouraging progress has largely been the result of prudent fiscal and monetary policies, as well as the steadfast implementation of structural reforms.
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> In the fiscal area, my authorities have brought the overall fiscal deficit (on a commitment basis and excluding grants) down from nearly 6 percent of GDP in 1994 to about 2 percent in 1996. During the same period, the basic fiscal balance has improved, with a deficit of about 2¼ percent of GDP turning into a surplus equivalent to 1¼ percent of GDP. A combination of revenue and expenditure measures has contributed to the improvement in the country's fiscal situation. To increase tax revenue from 12½ percent of GDP in 1994 to 14 percent in 1996, my authorities have made considerable efforts to further strengthen the tax administration with a view to combating fraud. As a result, income tax and revenue derived from value added tax was somewhat higher than programmed in the first quarter of 1997. For the period ahead, a number

of measures have already been taken to further improve the efficiency of the tax system. It is expected that revenue measures that were put in place in 1996 and early 1997 will improve tax collection and broaden the tax base. In addition, a comprehensive reform of the taxation and pricing of petroleum products will be undertaken in late 1997 and in 1998 in the framework of the energy sector reform. Regarding nontax revenue, additional revenue is expected from a four-year fisheries agreement with the European Union.

On spending policy, efforts aim at continuing to reduce the level of expenditure over the medium-term. In that context, it is to be noted that total government expenditure has been kept within the program limit, partly because of a cut in the wage bill. During the period ahead, the wage bill will also be contained by limiting the number of civil servants (excluding voluntary teachers) to its current level of 67,100 and by restricting wage increases. This restriction will be facilitated by the recent adoption by the National Assembly of the law on merit-based promotions.

On monetary policy, my authorities have taken advantage of the improved fiscal situation to reduce the net level of government borrowing from the domestic banking system. By contrast, however, credit to the private sector continued to rise in 1996, mainly because of increased lending for international trade, particularly for food imports, as well as investment in construction industry. With the continued decline in inflation, the BCEAO discount rate was lowered from 7.5 percent at the end of 1995 to 6.25 percent in February 1997.

On the structural front, it is important to indicate that there has been some increasing resistance by employees to public enterprise reform, mainly because of its social impact and in the absence of an appropriate social safety net. Despite this resistance, considerable progress has been achieved in public enterprise sector reforms with the withdrawal of government's monopoly position in public utility companies since the early 1990s. As a result, the management of the water company (SONEES) has been privatized, one-third of the capital of the telecommunications company (SONATEL) has been opened to the private sector and a reform of the energy sector is expected to lead to the privatization of the national electricity company. As regards the case of the energy sector, reform efforts are being pursued. A number of important measures, including the liberalization of the imports; transportation and distribution of petroleum products; and the abolition of special privileges granted to the petroleum company, will be implemented before the end of 1997. In addition, a law on the privatization of the electricity company (SENELEC) will be submitted to the National Assembly before the end of December 1997. Prior to that privatization, the government has agreed to arrange for a rapid audit of the company's financial statements for 1995 and 1996 and to accept that state ownership in SENELEC's capital be less than 50 percent. In addition, SENELEC's employees have been given priority, on a limited time basis, to buy 8–10 percent of the shares. To address the immediate problem of a substantial shortfall in electricity generation, SENELEC has signed a contract with a private foreign firm.

On financial sector reform, my authorities wish to report that Senegal's banking system is generally healthy and most banks were profitable in 1996 and their prudential ratios set by the regional Banking Commission were respected. To develop and strengthen the financial sector, the authorities are making efforts to improve the functioning of the banking system and develop nonbank and local credit institutions. These institutions will increase the availability of financing to small businesses and economic activity in rural areas. To reduce the risk of lending to the private sector, my authorities recognize the need to improve the application of business law by ensuring the enforcement of contracts. Successful actions in this area will increase the participation of the private sector in domestic economic activity.

In conclusion, my authorities would like to reiterate their commitment to the implementation of adjustment measures during the medium term and beyond. In that context, they are aware that continuing to improve Senegal's fiscal situation in a stable environment is essential in government efforts to promote growth and alleviate poverty. However, they are of the view that adequate support from the international community in the form of concessional loans or grants will be required in order to achieve the medium-term macroeconomic objectives of the country. Therefore, they hope that foreign financial assistance will be available in a timely manner, during the years ahead.

Mr. Morais made the following statement:

We are encouraged by the efforts of the authorities in carrying out the reforms envisaged under the medium-term ESAF-supported program initiated three years ago. During these years, growth has been stronger than expected, the inflation has declined significantly, and the external current account deficit has narrowed, leading to an improvement in the foreign reserve position. The authorities deserve to be commended for these achievements. The pursuit of tight financial policies has no doubt enhanced the progress toward macroeconomic stability.

It is, however, important that the momentum be sustained in the remainder of 1997. In this respect, we welcome the authorities' emphasis on advancing the process of fiscal consolidation. The focus on continued fiscal consolidation through revenue-enhancing and expenditure-restricting measures will enable the authorities to generate the savings required to sustain increased investment in infrastructure and human resource development. The intended comprehensive reform of the petroleum taxation and pricing system is also likely to contribute toward this effort. We would also encourage the authorities to eliminate tax exemptions where possible. On the expenditure front, measures aimed at containing the wage bill and reforming the public administration are steps in the right direction. This should enhance the efficiency of government spending and allow increases in outlays in key areas such as the social sector, infrastructure, and the judicial system. In particular, we welcome the draft law on merit-based promotions. If approved and implemented, it should—together with the policy of limiting recruitment—strengthen the process of rationalization of civil service, while contributing to the efforts at retaining the most qualified personnel. Moreover, we are pleased to note that privatization program will be accelerated, with the proceeds earned to be used for settling government liabilities.

In the area of monetary policy, there appears to be no major problems, as the banking system is broadly sound and the authorities' effort to contain inflation is producing results. However, as the staff has suggested, the reforms in the financial sector need to be deepened further in order to improve greatly the mobilization of savings and the allocation of credit. We also concur with the staff that promotion of nonbank and local credit institutions could play an important role in providing financing to small businesses. We welcome the authorities' intention to accelerate structural reforms, including the improvement of legal framework to create a more attractive environment for increased private sector participation in the economy.

With these comments, we support the proposed decision.

Mr. Schneider made the following statement:

We would like to commend the Senegal authorities for their performance under the current arrangement. Prudent macroeconomic policies are now beginning to bear fruit in the form of higher growth, lower inflation, and an improvement in external balances. In this context, we can certainly support completion of the mid-term review.

We generally agree with staff's analysis and recommendations. In particular, we support the three areas of focus mentioned in the staff appraisal—namely, further fiscal consolidation, stronger structural reform, and deepening financial intermediation. I would just like to make a few general remarks in this regard. First, we would like to emphasize the importance we attach to structural reforms. While Senegal has established a good record on macroeconomic management, such areas as privatization, civil service, and state enterprise reform have lagged behind. We can appreciate—as highlighted in Mr. Yao's statement—that these are difficult social and political issues, but we do need to bear in mind some of the lessons we have drawn from the recent review of experience under ESAF programs—in particular the need to accelerate structural reforms. In this context, I was glad to read in the staff report that the privatization process is once again gaining momentum. Indeed, the privatization agenda laid out in Box 2 seems appropriately ambitious, and we would urge the authorities to rigorously implement this agenda and avoid any further delays. This seems particularly the case for the electricity company, where the reform process has been slow.

The staff paper also mentioned efforts to improve the application of business law—primarily through strengthening the judicial system and revising current procedures for enforcing loan guarantees. We view this as a crucial step forward, and were glad to see that such measures are being addressed in conjunction with a focus on sound banking practices and effective supervision. Such steps are key to creating an efficient business environment, lowering the cost of capital, and boosting the confidence of private investors.

Lastly, we were struck by the discussion in the Selected Issues paper regarding fiscal policy. On the revenue side, performance looks broadly satisfactory, and we certainly support the government's long-standing efforts to rationalize the tax system and improve tax and customs administration. Nevertheless, we continue to be concerned about the composition of tax revenue, particularly the reliance on trade taxes—which now account for some 45 percent of total tax revenue. We would urge staff and the authorities to take a closer look at this heavy reliance on trade taxes in any future program. On the expenditure side, the Selected Issues paper raises a number of weaknesses in the budget process that were highlighted in a 1993 World Bank public expenditure review—such as year-to-year automatic appropriations with no review, a weak link between the current and capital budgets, and misclassification of current expenditures. Staff note that these weaknesses have not been corrected since that time, and I was wondering why this is the case. I was also struck by the fact that, despite rises in current spending allocated to education and health, provision of basic health care and primary education appear to have deteriorated in recent years. The lack of progress in these areas is reflected in the social indicators on page 28, where there seems to be little advancement since the 1980s. Thus, while overall expenditure levels are in accordance with program targets, it seems that there's a serious deficiency in the quality of expenditures and their administration. Paragraph 18 of the staff report mentions the preparation of a comprehensive, long-term reform of the public administration to address these problems. We would urge speedy completion of the associated public expenditure review, with close attention to measures that would boost the rate of return on health and education spending.

Mr. Kannan made the following statement:

We compliment the Senegalese authorities for their achievements which are remarkable. In a period of four years, inflation is brought well under control, fiscal deficit is significantly reduced and output growth is also improved. Furthermore, we are happy to note that quantitative and structural performance criteria and benchmarks for end-March, 1997 and structural benchmarks for end-June 1997 were observed. Now the moot question is how to sustain these favorable factors and move decisively in containing external current account deficit.

The achievement on the fiscal deficit side is commendable as the deficit has been brought down from 5.7 percent of GDP in 1994 to 2 percent in 1996. With a view to maintaining the current rate of inflation, and not to put undue pressure on monetary policy, it is important that the fiscal deficit reduction must be continued. In this context, the present trend of wage containment should be continued and we also encourage the authorities to complete the public expenditure review in the areas of education, health and judicial system with a view to enhancing the effectiveness of government spending. But I have one question for the staff. Given the present macro-economic set up, I am not clear whether it is appropriate to put heavy pressure on the authorities to achieve fiscal balance in 1998 as mentioned in the staff paper. Although the privatization is going on track, there are many areas where the government is having a lot of responsibility especially in improving social conditions which require heavy investment.

In the field of monetary policy, we agree with the present stance of the monetary policy and the present real interest rate at 3.5–4 percent is appropriate. It should be the endeavor of the authorities to continue this trend. We encourage the authorities to develop money and inter-bank markets with a view to intensifying the use of indirect instruments of monetary policy and to use interest rates as the principal element of the monetary policy and strengthen the supervision and control of the banking system and also to capitalize the banks adequately so that they are in a position to meet the competition from nonbanking financial institutions in future. The development of nonbanking and credit institutions is essential to increase the availability of financing to small business. In this context, the authorities may think about specialized institutions like Agriculture Refinance Corporation, Industrial Development Bank etc. The importance of appropriate business laws for ensuring prompt enforcement of contracts is to be duly recognized.

The staff have suggested a special training for judges and magistrates in financial matters. Many countries in this region have requested for similar assistance. In this context, the IMF Institute may think about conducting a training program or a regional seminar for not only Senegal but also for a number of other countries in the region.

Savings in the economy is very low and the banking system should be adequately used to improve the financial savings and efficient credit allocation. In this context, the authorities must pay sufficient attention in creating a regional stock market and also to develop a broad range of negotiable debt instruments.

In Table 8 on Balance of Payments, the staff have projected financing gap for the period 1997–99 whereas in para 31, the staff mentioned that the finance gaps from 1998–2005 are expected to be covered by debt relief as well as by external assistance from other bilateral or multilateral creditors. The staff may explain the risk associated with this forecast given the vulnerability of the exports to terms of trade shocks and the need to augment imports in the medium term period.

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

Mr. Rodríguez made the following statement:

I want to thank thé staff for providing us with useful and comprehensive information about Senegal. government authorities are commended for a successful implementation of ESAF program, fulfilling most performance criteria and structural benchmarks. The economic achievements have been remarkable, showing relatively high real growth rates of GDP, decreasing inflation rates, and lower current account deficits.

The fiscal deficit, as a percentage of GDP, has been declining steadily. The government has made a noteworthy, sustained effort to contain current expenditures, reducing them by three percentage points of GDP between 1994 and 1997. A similar effort has been made to reform the tax system, modifying tax code and tax structure, while improving customs and internal tax administrations. All this has generated a significant increase in revenues and the authorities should be commended for these accomplishments.

In this area I would like to make a few comments and the opinion of the staff would be most welcomed:

First, the increase in tax revenues for 1997, particularly in tax collection on goods and services, seems somewhat optimistic, because it is expected to double improvement achieved in past years.

Second, one of the measures to achieve fiscal targets is a wage freeze. Nevertheless, it is mentioned that school teachers and other groups have protested against this policy. As elections get closer, could this policy be relaxed if the pressure increases?

Third, I coincide with the staff, when they point out that, in spite of the achievements in increasing revenues and containing current expenditures, more efforts are needed in these areas so as to allow more spending in education and health. In this respect, UNDP-World Bank public expenditure review might show more efficient ways of allocating resources. Yet, given low enrollment rates and high ratio of students to teachers, it is surprising to see that the only increase in public employment would be that of voluntary teachers. Possibly, in those numbers there is already an increase in employment of paid teachers, which is being offset by a reduction of employment in other areas. Nevertheless, would it have been possible to hire more teachers, allowing perhaps a less ambitious fiscal target?

Fourth, the changes in taxation of petroleum products proposed by the staff could have a significant fiscal effect and would reduce the vulnerability of government revenues to changes in oil prices. However, given the magnitude of the price increase considered, this measure would probably have a significant effect on inflation and, thus, would be hard to introduce all at once. Maybe the staff has some suggestions to implement this proposal.

In the structural reform agenda, the Senegalese authorities, in a noteworthy effort, seem to have speeded up the pace of the privatization program and have strengthened the implementation unit. As the staff indicates, this should enhance credibility and confidence in the government and in the future of the economy. Nevertheless, as elections get closer, opposition to reform may intensify. Could the privatization program lose momentum as a consequence?

With these comments, I wish the Senegalese authorities success in the challenges ahead and I support the proposed decision.

Mr. Hammoudi made the following statement:

We wish to commend the authorities for their remarkable economic performance, including their observance of the performance criteria and benchmarks. This is reflected in substantial increase in real GDP growth, sustained low inflation, and a reduced current account deficit. On the structural front, despite some delays, the reforms have been impressive given the level of Senegal's administrative capacity and the social pressures that the country is facing, as described by Mr. Yao. This being said, we agree with the staff that further efforts are needed to improve the fiscal position, to make the economy more efficient, and to generate public support for the program.

To strengthen the fiscal position, the authorities need to make further efforts to improve the tax system, particularly as the current ratio of fiscal revenues to GDP is low. We encourage the authorities to continue rationalizing expenditures with the objective of increasing high priority outlays, such as education, health, basic infrastructure, and the judicial system. Completion of civil service reform and the privatization program will certainly result in more revenues and savings, which will help to strengthen the fiscal position.

To make the economy more efficient, the authorities need to accelerate structural reforms in the public enterprises, the financial sector, and the judicial system. Restructuring and effective privatization of public enterprises will boost investor confidence; we thus welcome the authorities' commitment to push forward with privatization and to liberalize the energy sector. The financial sector also needs to be made more efficient in order to stimulate savings and to improve resource allocation. Furthermore, reform of the judicial system will enhance public trust in government policies, and encourage foreign and national investors to become more involved in Senegal's economy. To improve the business climate, it is important that contracts be enforced strictly, which should help to reduce lending risks. Improved training in economics [for judges will be necessary if the application of business law is to be improved].

As the building of public support for the program will be vital to the success of the program, we welcome the authorities' efforts to inform the public about the content of the adjustment program, and its economic and social objectives. Claiming ownership of the program will certainly boost the authorities' credibility in international markets, and in Senegal's business community.

With these comments, we support the proposed decision.

Mr. Fujii made the following statement:

Like most Directors, I commend the authorities for having successfully implemented the ESAF program and for having maintained a favorable economic performance. I share the staff's view that in order to boost economic growth, the authorities should focus on continuing fiscal consolidation by strengthening structural reform, and deepening financial intermediation. I hope that, following the staff's advice, the authorities will successfully stimulate the private sector and improve economic performance.

Let me make some brief comments on specific policies.

Regarding the external sector, I am pleased to say that the current account balance is improving. However, I would note that the trade balance has consistently been in deficit and there has been a deficit in services as well, despite recent improvement because of increases in receipts from tourism. The fact that these deficits have had to be compensated for from official transfers points to the vulnerability of the external position. It seems to me that in order to increase exports and improve the current account balance in the medium term, the authorities should boost investment and achieve a greater diversification of the industrial base. To this end, it is important to implement the adjustment policies recommended by the staff, such as increases in capital outlays, acceleration of structural reform, and improvement of financial intermediation.

I am pleased to see that the external debt is at a sustainable level, as indicated by the ratio of debt to exports of goods and nonfactor services in NPV terms and the debt-service ratio. I hope that the authorities will continue to improve the debt situation through prudent debt policies and by maintaining the confidence of the international community.

With these remarks, I support the proposed decision.

I wish the authorities every success.

Mr. Goffinet made the following statement:

I congratulate the Senegalese authorities, who have been implementing an ambitious program of stabilization and structural reforms for some years, on the impressive results they are achieving. The results of their comprehensive structural adjustment strategy are seen in a higher than expected economic growth rate, low and stable inflation, and the ongoing consolidation of the fiscal position. Competitiveness has been improved, and the ground has been prepared for development of the private sector. The staff reports underlines that almost all quantitative and structural performance criteria and program benchmarks have been observed. The goals and outlook for 1997 are promising.

Despite these good results, however, Senegal's fiscal situation remains fragile, and the authorities will have to continue and intensify their drive to strengthen their fiscal policies. Despite the authorities' recent efforts, current revenues are 15 percent of GDP, which is somewhat low in particular to support a spending increase in high priority areas essential to keep growth on its upward path and ensure the continued improvement of living standards. The areas most in need of increased support are health, education, public investment, and the judicial system. The recent improvement in tax collection is commendable. Now it is time to accelerate the overhaul of the system for pricing and taxing petroleum. The present restrictive approach toward current expenditures should be firmly maintained by curbing nonpriority expenditures, contain the public wage bill, reorganize the national retirement fund, and reform the public administration.

The further development of a financial sector in Senegal, which is basically healthy, has run up against serious obstacles, many of which originate in the judicial system. Senegal needs an efficient and modern banking sector in order to encourage domestic savings, which remain low in GDP terms, and mobilize them to meet the credit needs of the economy. I therefore strongly urge the authorities to proceed with the restructuring of the financial and banking sectors.

I was disappointed by delays in the privatization of public enterprises and by the slowness of important structural reforms in other areas such as the civil service and the judicial system. I encourage the authorities to intensify their efforts in these area. Structural reforms are the key to reducing destructive economic distortions, ensuring continued growth, protecting Senegal's competitiveness, and fostering the confidence which is essential for the development of Senegal's private sector.

The staff reports that Senegal's performance in the collection and provision of statistical data is weak both as regards the quality of the data and the timeliness of their presentation. Since economic data are the stars by which economic policy must be steered, I strongly urge the authorities to begin remedial action immediately.

The staff paper also notes that political and social tensions have intensified during 1997 and may increase further as the 1998 elections approach. I would like to ask the staff if they can tell us how seriously these tensions may threaten Senegal's overall economic stabilization process.

Finally I agree with the proposed decision, and wish the authorities every success in their endeavors.

Mr. Borpujari made the following statement:

Senegal's continued economic progress is encouraging. Last year's pick up in growth and deceleration of inflation exceeded program targets. The fiscal and external payments positions have also improved further, and the overall outlook remains promising. However, the recovery is still fragile. Full and timely implementation of the program is therefore critical. Here, I agree with the thrust of the staff recommendations and will only add a few remarks.

On the fiscal front, the priority for current spending curbs and a more growth-prone outlay pattern is well-placed. However, like Mr. Schneider, I am struck by paragraph 31 on page 16 of the background paper which emphasizes the difficulties of separating current and capital spending because of extensive budget process problems, including frequent double-counting and misclassifications. Indeed, the staff traces these difficulties to the authorities' failure to address problems already identified in a 1993 World Bank review. Thus, prior reform of the budget process appears to be an essential prerequisite for the proposed fiscal reforms. The staff comments will be welcome.

Regarding monetary policy, I welcome the authorities' determination, in the context of the WAEMU, to further develop the money and interbank markets, and to ensure that interest rates remain market-determined. However, I am not clear about the likely overall impact of the recently proposed measures for increased agricultural financing that the staff report refers to in paragraph 21. I will appreciate staff comments on this issue.

On the structural policy front, I am encouraged by the authorities' resolve to accelerate the privatization drive, and the reform of the civil service and the judiciary. The consensus on the crucial importance of an efficient financial intermediation process is also welcome. In that regard, a key challenge is to both expand the banks' currently narrow client base and improve the rate of loan recovery. Here, improved bank supervision, broadening of debt instruments, and strengthening of the financial sector's legal framework are steps in the right direction. The authorities should now follow up on the report's several helpful suggestions to take the process forward.

Finally, I am reassured by the government's prudent management of both the domestic and the external debt. Earmarking of privatization receipts for reduction of the government's debt and extrabudgetary domestic arrears is a welcome move. Externally, regularization of relations with all creditors as well as continued strict adherence to the limitation of all financing to concessional loans and grants will remain crucial.

With these remarks, this chair wishes the authorities further success.

Mr. Kaufmann made the following statement:

I concur with staff that Senegal has made important progress in addressing its macroeconomic imbalances over the last three years. Given the long history of Fund-supported adjustment—this is the eighth annual arrangement under SAF/ESAF—it is crucial that this program succeeds in putting the economy on a solid and sustainable growth path. The chances for this are good. In my view, there has been an important qualitative improvement in the adjustment process since the devaluation of the CFA-franc in 1994. One of the major factors for this is undoubtedly the authorities' strong commitment to achieving the goals of the current adjustment program.

Notwithstanding this altogether positive outlook, the staff assessment points to some important weaknesses, which I would like to comment on, first starting with fiscal policy, then turning to structural reforms, and concluding with the political background for economic reforms.

First, on fiscal policy: although important progress has been achieved in consolidating the fiscal deficit, in my view this area remains Senegal's Achilles heel. The efforts made in fiscal adjustment since 1986, which are well described in the Selected Issues Paper, have not been very successful in establishing a sustainable revenue base. Senegal continues to have a low revenue-to-GDP ratio. As staff correctly points out, this was essentially due to the ad hoc nature of the measures combined with a stop-and-go attitude. This is somewhat surprising, given that the Fund and the Bank have delivered substantial technical assistance in this field. Could the staff comment on how effectively technical assistance was used in the past?

A stronger revenue base is essential for Senegal to be able to allocate sufficient resources to high priority areas such as health and education. As to the quality of the revenue-enhancing measures, I agree that they go in the right direction. However, I note that the share of taxes on foreign trade in total revenue has nearly reached the 50 percent mark. Senegal should thus urgently try to increase tax yields in other categories. This is especially important in view of the future tax harmonization within the West African Economic and Monetary Union, which could impact significantly tax revenues stemming from imports.

On expenditures, I agree that more resources ought to be allocated to investments in human and physical capital. However, the present compression of other expenditure, with budgetary allocations decreasing in nominal terms, is in my view not sustainable.

On my second point, the area of structural reforms, staff is quite candid about the fact that progress has been slower than envisaged. This is especially true in the areas of civil service reform, privatization, and reform of public enterprises. I realize that strong interest groups are involved in maintaining the status quo. However, as the recent review of ESAF programs has shown, structural reforms are essential for promoting private investment and entrepreneurship. In an environment of increasing globalization, private economic actors can and will not wait for Senegal to implement the planned reforms. It seems evident that the slow progress is this area could prove to be an important stumbling block in Senegal's path to establishing a solid growth potential.

Finally, staff mentions the increased political and social tensions in early 1997. While it is true that currently protest stems largely from special interest groups, it is important not to underestimate the fragility of public support. Public acceptance of the adjustment program, which the authorities consider to be high, hinges on the rapid materialization of the benefits of adjustment. This again depends essentially on the buoyancy of the private sector. To achieve this aim, adjustment momentum must be kept and also politically difficult reforms should be implemented rapidly. The legislative elections next May will prove to be an important test for the Senegalese adjustment process.

With these remarks we support the proposed decision.

Mr. Fayolle made the following statement:

I am pleased that this program is well on track. I welcome the staff appraisal which underlies the fact that Senegal's achievements have been considerable during the current three-year ESAF period and that the authorities' implementation of the medium-term adjustment and reform strategy has been largely satisfactory. This country really presents an encouraging case and the authorities should persevere in this way.

Basically, I share the staff's analysis and I am in broad agreement with their recommendations. Let me just emphasize some issues and make some comments.

Real GDP increased by about 5.5 percent in 1996, above the original program's objective which was considered as a great challenge. But despite the fact that growth is projected to remain relatively strong in 1997, it will be lower than the previous year, because of a significant drop in agricultural production caused by irregular rainfall. This perspective highlights the necessity to diversify the Senegalese economy, which is still limited in order to increase the average growth rate in the medium-term period.

I welcome the progress made on the privatization front; for example, the management of the water company or the opening up of capital of the telecommunications company. However, delays in the energy sector reform are regrettable. This reform is crucial to enhance the credibility of the government's reform program to improve competitiveness of the Senegalese economy and to bolster private investor confidence.

As regards the structural reform process, I welcome the progress made on the privatization front, for example, the management of the water company (SONEES) or the opening up of capital of the telecommunications company (SONATEL). However, significant delays in the energy sector reform are regrettable. I fully support the staff's emphasis on this point and their recommendations. The energy sector reform is indeed crucial to enhance the credibility of the government's reform program, to improve competitiveness of the Senegalese economy and to bolster private investor's confidence.

On the financial sector, which remains thin in Senegal, I share the idea that the development of non-bank and local credit institutions to finance small businesses, the informal sector and rural areas is useful. But this development should only be an additional component of the financial system and not a factor for reducing the formal banking sector. Without being too restrictive about new institutions, weakening the current formal banking system, of which the network is indispensable, should be avoided.

On the need to improve the application of business law, I welcome the staff's emphasis on this question and I am confident because, since the beginning, Senegal has been playing an important role in this regional framework (OHADA).

Finally, I approve the proposed decision and, pending full implementation of the current adjustment program, I understand the Senegalese authorities' desire to negotiate a new ESAF arrangement in order to consolidate the gains achieved so far and to pursue structural reforms, including the impact, especially from a fiscal point of view, of the trade liberalization reform.

Ms. Pinzani made the following statement:

The macroeconomic results achieved in 1996 are positive, and offer Senegal a window of opportunity to make a breakthrough to sustained growth. However, the still-low level of revenues, the inefficiencies in expenditure monitoring, and the continued postponement of the energy sector reform do not make it any easier for the authorities to adopt adjustment policies capable of building upon these macroeconomic achievements.

A country in which population growth remains a major constraint to development, the largest portion of the productive sector remains highly vulnerable to climatic vagaries and to international price fluctuations, and fiscal consolidation remains reliant on the provision of large grants, the credibility of the government's reform program has to be enhanced. This means that the authorities should decisively strengthen their efforts to reduce macroeconomic imbalances and to foster structural reforms. This should be done coherently and consistently over time, as it will be instrumental in a favorable consideration by the Fund of a possible further ESAF arrangement.

We are convinced that the authorities still need to take relevant measures in the areas of fiscal consolidation, structural reform, and financial intermediation to ensure that any further ESAF arrangements provided to Senegal can be used efficiently.

In the area of deepening financial intermediation, I wish to reiterate the position expressed by my chair at the discussion of the request for the second annual arrangement, namely, that the expansion of the financial sector should be accompanied by a strengthening of the supervisory system. Such a strengthening should guarantee a level playing field for the existing categories of financial institutions, while maintaining a high standard of prudential requirements. In this respect, our suggestion is to envisage a sort of plan to keep track of microfinancial institutions and to ensure that their activities are subject to the same restrictions as applying to banks. Given that the profitability of banks was restored only recently—after a long process of restructuring—and that capital adequacy requirements are very low compared with international standards, we are puzzled by the staff's suggestion to relax banking regulations.

We also wonder if the staff would explain why nominal GDP growth of 8.4 percent in 1996 was compatible with growth of the money supply of 3.1 percent, while nominal GDP growth in 1997 only 0.2 percentage points faster than in 1996 is regarded as compatible with a much larger increase in the money supply, of 8.3 percentage points. The rate of growth of the money supply has also been revised upward for 1998. Has there been a structural upward shift in the demand for money? If so, what are the reasons for this shift?

The staff representative from the African Department remarked that some of the weaknesses identified by the public expenditure review in 1993 had been corrected. A further public expenditure review was being conducted in the current year, which should help to identify how to make the public expenditure process more efficient, including the effectiveness of spending on health, education, and judicial reform. The authorities' budgetary procedures were largely adequate, but needed to be implemented more effectively. To his knowledge, no technical assistance had been delivered since the 1993 public expenditure review, which had been followed shortly by the devaluation of the currency.

Regarding the effect of the forthcoming election on wages and on the privatization program, the authorities had recently reached an agreement with teachers, including continued wage restraint and an extension of the school year, the staff representative indicated. Teachers' wages were thus unlikely to present a problem in the run-up to the elections. As for the privatization program, there was relatively widespread support in Senegal for it. While the staff had not yet received official confirmation, it understood that one-third of the capital of the telecommunications company (SONATEL) had recently been privatized, which was an important step in maintaining the momentum of the privatization process.

If the value-added tax on imports was included in the figure on trade taxes, those taxes amounted to about 50 percent of total fiscal revenues, the staff representative noted. However, if the value-added tax on imports was excluded from trade taxes, the latter would amount to about 34 percent of total fiscal revenues. That figure would likely fall further following implementation of a common external tariff, which Senegal was currently discussing with its WAEMU partners—indeed, average tariff rates were likely to fall substantially.

It was not correct to characterize the Fund as putting heavy pressure on the authorities to strengthen the fiscal balance further, the staff representative said. Fiscal adjustment was the authorities' own objective, about half of which had been achieved through revenue measures, and the other half through reductions in low priority spending. Fiscal consolidation, indeed, had been accompanied by increased spending on the social sectors and on domestic investment. The important issue was not as much the level of spending but the efficiency of spending. There was considerable scope for the authorities to increase the efficiency of spending on health and education. For example, it was not obvious that the number of teachers needed to be increased; too many were in administrative positions in the capital city and too few in rural classrooms.

The government's agricultural investment program included agricultural credits through the National Agricultural Credit Bank of about CFAF 15 billion, the staff representative recalled. The government had assured the staff that credit would be allocated on the basis of market criteria, to avoid the problems of nonperforming loans that had occurred with the former agricultural development agency (ONCAD).

It was correct that, under the original program, money growth had been substantial between 1996 and 1997, the staff representative said. While there had been some problems with the money supply data—associated with the introduction of new reporting requirements by the BCEAO—money growth would be relatively stable under the new program. Projected money growth was broadly in line with nominal GDP, reflecting much greater allocation of credit to the economy.

Tax revenues had exceeded the program benchmarks in the first two quarters of 1997, the staff representative observed. Income tax revenues had been about CFAF 7 billion higher than projected and value-added tax revenues about CFAF 1.5 billion higher, reflecting the delayed benefits of the measure taken by the authorities to widen the tax base and to increase the efficiency of tax and customs administration.

The staff had not suggested relaxing banking supervision at the level of the regional banking commission, but that some regulations on leasing companies and micro finance institutions be relaxed to encourage the development of those entities, the staff representative clarified.

The staff representative from the World Bank said that the Bank had assessed the failure of the first public expenditure review in 1993, and had discussed the case of Senegal at an SPA (Special Program of Assistance) meeting in the past year. The SPA meeting had concluded that the public expenditure review had failed mainly for three reasons: first, the review had been driven by consultants of the Bank, and had lacked participation by the government; second, it had taken too long, having been under way from 1986–93; and third, its recommendations had not been sufficiently specific to be useful. The Bank had sought to avoid all of those mistakes in its second public expenditure review.

The authorities had requested a second review to help translate political decisions on expenditures—made at the level of the parliament and finance ministry—into expenditure decisions based on more economic criteria, which had not been the case over the previous decade, the staff representative noted. The Bank and the authorities had held a workshop in June 1997, to initiate the second public expenditure review. At the workshop, the authorities had described the budgetary system in place in Senegal and their need for assistance; and the Bank, together with consultants, had described the state-of-the-art in public sector reform, focusing on a few successful cases, such as New Zealand and Australia and some other OECD countries—as there were few cases of successful public sector reform to choose from among developing countries.

The authorities were courageous and willing to take the lead in securing substantial reform of public expenditures, the staff representative remarked. For example, they intended to proceed with a program-based budget, which would result in a major change in the budgetary process, particularly in political discussions of expenditure priorities and in expenditure management. Such a budget would also result in the unification of decisions on both investment and recurrent expenditure, and a complete change of the budgetary information system. The second public expenditure review would also include a medium-term expenditure framework, which would be essential in integrating investment and recurrent expenditure, and in setting a hard budget constraint on sectoral expenditures—not merely on overall expenditures. The experience of the previous few years indicated that an overall budget constraint or cap could be arbitrary in its effects, resulting in cuts to development and social expenditures, which were vital to future growth in Senegal.

The three sectors in which the authorities would complete the public expenditure review were health, education, and the judicial system, the staff representative pointed out. In the health sector, it would be relatively easy for the authorities to mobilize financing and to decide on new procedures in implementing an innovative public expenditure process, as studies had been under way for two years on harmonizing donor support for that sector; the Bank was financing training of staff; and a new computer system was in place for budgeting. While the education sector was subject to numerous political problems, a program-based budget should be helpful in that sector. Together with the Bank and consultants, the authorities were designing a system that would set educational targets, such as achieving a literacy rate of 75 percent, and that would assess the expenditures required on teachers and equipment, for example, to reach those targets. Teachers' salaries in future years would then be projected according to the alternative salary structures. It was evident to the Senegalese public that the present salary structure for teachers was unaffordable for the government to attain even modest educational objectives, such as a 75 percent enrolment ratio in elementary schools. The public expenditure review was a participatory one that would include discussion with all stakeholders in the educational system, including parents—and not just stakeholders with access to the press, such as teachers' unions. The staff hoped that the public expenditure review would be compatible with meeting several objectives, namely, securing public participation, focusing on priority expenditures, and achieving macroeconomic stability.

Mr. Yao commented that he wished to thank Directors for their encouraging remarks. He wished to reiterate the authorities' commitment to the adjustment process, focused on fiscal consolidation. The latter was not the result of pressure from the staff, but of the authorities' belief that future growth and development hinged upon a sound financial policy in Senegal. Tax revenue had increased from the equivalent of about 12 percent of GDP in 1994 to about 14 percent of GDP in 1996, with further increases expected in the near future; indeed, tax revenues had well exceeded program targets in the first six months of 1997. While a few difficulties remained on the expenditure side of the budget, it was important to note that current expenditure had declined from about 15 percent of GDP in 1994 to about 12 percent of GDP in 1996, and that further reductions were expected in 1997 and 1998. The authorities were seeking to keep capital expenditure constant as a percentage of GDP, while constraining expenditures that needed to be constrained, especially wages and salaries, which had been set at CFAF 166 for 1997.

The authorities would seek to restructure the state enterprises, which were a heavy burden on the budget, Mr. Yao noted He had just been informed that they had privatized one-third of SONATEL, and had received payment for it. The authorities had assured him that they would restructure the energy sector, and that they had the support of labor unions to that end.

Mr. Kannan clarified that his earlier point had not been that the staff was pressuring the authorities with the program. Instead, he had wondered whether or not it was appropriate for the Fund to aim at the achievement of fiscal balance in 1998 when the Senegalese government had heavy responsibilities for improving social conditions, requiring substantial infrastructure investment.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the performance under the program supported by the third annual arrangement under the Enhanced Structural Adjustment Facility (ESAF), noting that all quantitative performance criteria for the end of March 1997 had been met. Most of the structural performance criteria and benchmarks had also been met, although implementation of some others had been delayed. Directors observed that economic growth in 1996 had been stronger than anticipated, inflation had continued to decline, and the external current account deficit had been further reduced. They commended the authorities' efforts in furthering price and trade liberalization and in improving the regulatory framework to provide an environment more conducive to private sector activity.

Notwithstanding those improvements, Directors underscored that Senegal's economic situation remained fragile. They urged the authorities to persevere with their reform efforts and to avoid any policy slippages. Directors stressed the need to consolidate the improvement in the fiscal balance in 1997 by increasing the revenue ratio and continuing to restrain nonpriority current spending in order to create room for increased spending in high priority areas. They welcomed the improvement in tax collection and urged the authorities to continue their efforts to rationalize the tax system, widen the tax base, and reduce the reliance on taxes on international trade. On the spending side, Directors stressed that it was essential to contain the wage bill at the programmed amount by limiting recruitment and avoiding general wage increases. In that context, they welcomed the recent adoption by the National Assembly of the law on merit-based wage increases, and highlighted the importance of implementing other aspects of civil service reform. Directors also stressed the importance of holding down nonpriority outlays and strengthening the budgetary process to avoid extrabudgetary spending. They urged the authorities to clear domestic extrabudgetary arrears. At the same time, Directors highlighted the necessity of increasing the level and effectiveness of priority spending on basic education, primary health care, the judicial system, and infrastructure.

Directors emphasized the importance of developing and strengthening the financial sector. They urged the authorities to ensure banks' strict adherence to sound banking practices and to enforce the prudential ratios set by the regional banking commission. They also encouraged the authorities to deepen financial intermediation, and noted that the creation of the regional financial market and the improved application of business law to ensure the prompt enforcement of contracts would be important to mobilize savings more effectively and to promote private investment. The development of nonbank and local credit institutions was expected to increase the availability of financing to small business.

Directors regretted that, notwithstanding the progress in structural reforms over the previous three years, there had been repeated delays in the implementation of privatization, public enterprise reform, and energy sector reform. They noted that the authorities had taken steps recently to make up for delays in those areas, including the reacceleration of privatization. They urged the authorities to fully implement the structural reform agenda envisaged in the program in order to enhance the credibility of their adjustment efforts and to bolster private investors' confidence.

Directors noted that, based on current policies, Senegal's balance of payments and its external debt service were expected to remain sustainable.

They underscored the importance of continuing to pursue a prudent debt policy that relied on concessional loans, especially as the debt burden remained high relative to government revenues.

Directors urged the authorities to improve further the quality and timeliness of the statistical database, particularly in the areas of the national accounts and the balance of payments.

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

The Executive Board took the following decision:

1. Senegal has consulted with the Fund in accordance with paragraph 2(d) of the third annual arrangement for Senegal under the Enhanced Structural Adjustment Facility (EBS/96/200, Sup. 1) and paragraph 5 of the letter of the Minister of Economy, Finance, and Planning, dated November 7, 1996, attached to the arrangement.

2. The letter dated May 20, 1997 from the Minister of Economy, Finance, and Planning shall be attached to the third annual arrangement for Senegal, and the letter of November 7, 1996 from the Minister of Economy, Finance, and Planning, together with its attached Memorandum of Economic and Financial Policies of Senegal for 1996–97, shall be read as supplemented and modified by the letter dated May 20, 1997.

3. The Fund determines that, notwithstanding the nonobservance of the structural performance criterion regarding the delivery by end-March 1997 of the report on the strengthening of the tax and customs administrations, the midterm review contemplated in paragraph 2(d) of the third annual arrangement for Senegal has been completed and that Senegal may request the disbursement of the second loan specified in paragraph 1(b) of the same. (EBS/97/130, 7/14/97)

Decision No. 11551-(97/78), adopted
July 28, 1997

6. ERITREA—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Eritrea (SM/97/184, 7/11/97). They also had before them a background paper on selected issues in Eritrea (SM/97/191, 7/14/97).

Mr. Morais made the following statement:

At independence in 1993, and after 30 years of war that left economic and social infrastructure devastated, the Eritrean authorities embarked on market-oriented macroeconomic policies and structural measures, geared toward achieving price stability and promoting the private sector as the backbone of the economy. The fruits of this effort are evident, inflation has dropped to single digits in 1996 and real GDP growth has averaged 6.5 percent for the past 3 years, providing for significant growth in per capita income. Substantial economic restructuring has been undertaken, and the structure of the economy has undergone tremendous transformation with industry boosting its share of GDP from 19.2 percent in 1992 to 27.4 percent in 1996, contributing to a considerable easing of domestic supply constraints. Private inflows have increased substantially, reflecting the strengthening of investor confidence in the country, and gross official reserves have increased from 0.2 months of imports in 1992 to 4.1 months in 1996.

Pressures on the budget, stemming from, among others, huge resource demand for reconstruction of physical infrastructure, resettlement of returning refugees, demobilization of ex-combatants and compensation of war victims have tapered off, and the authorities are now focusing on measures to bring down the deficit to sustainable levels. In this regard, the size of the civil service was reduced by one-third and that of the defense forces by 54 percent. The impact of the new and competitive pay scale for the civil service has been partially offset by the substantial downsizing, and the total wage bill for 1997 will be contained at the 1996 level. government transfers and other expenditures will be reduced. The authorities are taking steps to improve revenue collection and customs administration and they will introduce other tax measures. In this regard, the deficit for 1997 is expected to decline substantially to about 8 percent of GDP from about 16 percent in 1996. The composition of government expenditure is also being improved, emphasizing the areas that can boost the long-term growth potential of the economy. These include investment in education and health, and improvements in infrastructure (roads, bridges, electricity generation, telecommunications, railway networks, port facilities, etc) in order to expedite the movement of goods and services.

The authorities are fully aware that the need for a formal budget process is urgent, including the introduction of rolling budgets and an expenditure control mechanism. They are moving expeditiously in this direction to make fiscal planning more transparent and enable rigorous monitoring of fiscal developments. Their priority had been capacity building, entailing total reconstruction of the civil service, with a view to creating a lean, efficient and decentralized government that would focus on policy formulation, regulatory functions and manpower development. Particular emphasis was given to strengthening the capacity for macroeconomic management in the Ministry of Finance, the Bank of Eritrea and other economic ministries. These institutions are now in a position to receive and absorb the technical assistance that the country desperately needs.

Additional structural reforms have been undertaken. The privatization agency is in the process of selling-off a large number of public enterprises, through international competitive bidding. In 1997 alone, 39 additional enterprises, that accounted for about 7 percent of estimated 1996 GDP, are slated for privatization. Substantial decontrol of prices and liberalization of exchange and trade has also taken place. Regarding the financial system, a new legal framework for the banking system is now in place. It grants independence to the central bank and gives it full powers on licencing, supervision and regulation of the financial system. Measures are also being taken to improve the soundness of the banking system while competition will be enhanced through licencing of private banks, including foreign banks.

To enhance the effectiveness of monetary policy, the central bank is strengthening its institutional capacity with a view to introducing monetary programming. Notwithstanding the moderation in inflation, the authorities remain concerned about monetary aggregates and intend to tighten liquidity by imposing a 20 percent mandatory cash reserve requirement on commercial banks. They will also sell securities to absorb excess liquidity. In addition, they are developing noninflationary instruments for financing the budget deficit. They will timely introduce these measures in order to further reduce inflation to 3 percent in 1997.

The authorities are moving ahead with plans to introduce their own currency. They are emphasizing adequate policy, legal and administrative preparation and the staff advice in this regard is well taken, particularly on proper management of fiscal, monetary and exchange rate policies. The authorities have already made use of Fund technical assistance in this area and will continue to do so.

Eritrea has continued to liberalize its exchange and trade regime. All quantitative restrictions have been eliminated, tariff bands were reduced to eight and steps are being taken, in consultation with the common market for Eastern and Southern Africa (COMESA), to further rationalize and reduce the tariff rates. The exchange rates have been unified at the level of the parallel market rate and a more liberal exchange regime is being pursued.

The Eritrean authorities have remained cautious in contracting new external debt and have borrowed only at highly concessional terms. Thus the debt-to-GDP ratio has remained very low, in single digits, and debt servicing remains negligible. Moreover, the authorities have moved even faster than many debt- ridden countries to establish a unit for public debt management in the Ministry of Finance.

The statistical data base is being improved in order to strengthen policy formulation and the monitoring of economic developments. Priority is being given to monetary, price, trade and national accounts statistics. Technical assistance will be sought in this area.

Regarding the medium-term, the authorities are preparing a National Policy Framework Paper that will provide a clear direction of their medium-term policy strategy, on which they will be consulting very closely with the staffs of the Bank and the Fund.

Extending his remarks, Mr. Morais said that he had just received comments from the Acting Governor of the Bank of Eritrea, who had indicated that the authorities generally agreed with the staff's assessment of monetary and fiscal conditions, and with the remedial steps identified by the staff, which the authorities were committed to undertaking. Both the

Bank of Eritrea and the government were firmly committed to maintaining the strong momentum in place to formulate and implement effective monetary and fiscal policies.

The authorities had already developed a general framework for monetary policy, and would pursue a market-based exchange rate policy after introducing a national currency, Mr. Morais continued. Minimum reserve requirements were in effect; measures had been taken to establish a money market, in which treasury bills would be auctioned and the authorities expected, in the near future, to begin open market operations and discounting. Moreover, the Bank of Eritrea had made significant progress not only in securing the necessary legal powers to conduct an independent monetary policy, but also in recruiting monetary economists and other experts. The Bank was currently assembling a team of experts who would form a monetary policy committee, which would soon consider developing instruments to control the money supply and to take steps to mop up any excess liquidity in the system. Based on its newly enacted legal powers, the Bank of Eritrea was also preparing guidelines and procedures for the establishment of private financial institutions, including banks, which would help create a competitive market in which interest rates could be set freely. As a result, the authorities would be able to abandon the current administered system of interest rates.

Regarding the balance of payments prospects and debt sustainability, the authorities were confident that the downside risks mentioned by the staff on page 28 of its report would not materialize, Mr. Morais stated. Over 1992–96, export earnings had been increasing at an average annual rate of 68 percent—albeit from a low base. The authorities were seeking to diversify the export base; to develop supporting services; and to link the rural economy with the modern sector—through improved infrastructure and other measures—which should help to increase further export earnings in the near to medium terms. Moreover, the authorities' firm commitment to prudent, market-oriented policies would continue to strengthen investor confidence and attract more remittances and private inflows.

The basket of the Bank of Eriteria's consumer price index included medical services, drugs, and sundries. Also, data on housing rent were regularly collected and computed, although not included in the final report, Mr. Morais added.

Mr. Watal made the following statement:

> Since 1993 Eritrea has been making good progress in working toward the building of public economic institutions which have a balanced market orientation. The authorities have also exhibited strong commitment to a development strategy which gives high priority to a stable macro economic environment. There is no doubt that the authorities must be commended for the continued economic reconstruction effort and for achieving a growth in GDP of 7 percent while keeping inflation at a low of 3.4 percent despite the drought conditions which had affected agricultural output in 1996. We are equally glad to note the earnestness of the authorities in their preparations to introduce a national currency which is a fundamental element of a country's identity.
>
> The Eritrean authorities have reasons to be proud of their performance in spite of being a vulnerable and an undiversified economy and we sincerely wish to have our appreciation recorded for the several achievements of Eritrea since the last Article IV consultation.

We are in broad agreement with the analysis and appraisal of the staff and are glad that the authorities have found the policy dialogue with them useful. However we would like to mention a few points for the sake of emphasis. During the last consultation the concerns regarding weaknesses in the macroeconomic indicators had been highlighted. From the staff report it is clear that fiscal imbalance, excess liquidity in the banking system, and deterioration of the external account still remain sources of worry.

Even though the overall fiscal deficit declined in 1996 there was a fall in overall revenue on account of lower dividend payments by public enterprises. Similarly even though expenditure went down the wage bill increased sharply. The budgetary management thus manifests sharp internal angularities. The staff has rightly advised that there should be comprehensive budgetary management to consolidate the budgetary performance. In addition the increasing domestic debt from 2 percent of GNP to over 30 percent in 1996 is indeed worrisome. We would like to know from the staff about the current status of the implementation of the fiscal package proposed by them and whether the overall deficit will be brought down to 8 percent of GDP in 1997 as indicated in Mr Morais' helpful statement?

On the monetary front, the authorities' commitment to control liquidity with the aid of monetary instruments is welcome but we have some reservations about the existing institutional capacity within the Bank of Eritrea even though there has been an enactment of law to regulate the financial institutions. The authorities it has been mentioned have already made use of Fund technical assistance. Would the staff elaborate how this support is being continued and whether it will be adequate for the authorities to build necessary internal capacity in a short time frame?

The sharp deterioration in the external current account and the stagnation of exports in convertible currency shows that the economy will continue to remain very vulnerable externally. The decline in the birr reserves and very little improvement in the convertible currency official reserves makes it necessary for the authorities to ensure judicious use of foreign exchange reserves. In this context while the authorities commitment to have a market driven exchange rate system for the national currency is welcome we strongly urge that necessary assistance should be provided to the Eritrean authorities to sequence and operationalize the conversion to the new currency. At the same time the authorities must keep an ever vigilant eye on external debt position even though the stock of debt and the quantum of debt servicing is not very significant in the current context.

Eritrea's domestic social and demographic indicators have to be improved in the shortest time frame. We congratulate the authorities for setting a high priority on improving social services and upgrading the education and health delivery systems. However we also feel that apart from an emphasis on health, nutrition and education programmes the authorities must concentrate on a comprehensive approach toward drought proofing the economy. This would also facilitate macro economic stability in the future. This approach may require detailed project planning and extension support at the micro level. We would wish to know whether any measures have been contemplated in this direction either by the authorities or the World Bank?

With these observations, we congratulate the staff for providing an excellent report and we would like to wish the Eritrean authorities well in their future endeavors.

Mr. Yakub wondered how the economy could be drought-proofed, particularly as droughts were beyond the authorities' control.

Mr. Watal responded that economies could be drought-proofed through a variety of area and local development programs, including water management and harvesting, which had been used in many countries. The authorities and the World Bank might have already considered the matter.

Mr. Borpujari made the following statement:

This chair welcomes Eritrea's improved economic performance over the past year. Growth more than doubled while inflation decelerated sharply. Sustaining this performance requires strong action to address the large fiscal imbalances and advance structural reforms.

As I am in broad agreement with the thrust of the staff appraisal, I will be brief.

Fiscal consolidation is a priority. While advancing the recovery requires continued substantial investment in infrastructure, it is clear that recent fiscal deficits are not sustainable. Therefore, it is important for the authorities to put in place a comprehensive medium-term framework to address these issues. Efforts should focus on reducing spending and reorienting it toward infrastructural projects. In this regard, containing the wage bill is essential. Efforts are also needed on the revenue front. Improving income tax collections and strengthening custom's administration are steps in the right direction.

A strengthened fiscal stance coupled with strong policy action in the monetary and financial sector are essential preconditions for the successful introduction of the nakfa. In this context, I am encouraged by the authorities' plan to mop up excess liquidity. These efforts will be greatly facilitated by moving to market determined interest rates. Facilitating market entry of new financial institutions would enhance competition and increase the efficiency of the system. It is important, however, that adequate regulatory and supervisory structures are first in place.

Structural reform is also needed for sustained high growth. While I note the progress made so far, further price liberalization and continued efforts to improve the efficiency of public enterprises and remove bottlenecks are still needed. In this connection, I welcome the authorities' privatization program and support increased private participation in infrastructural projects.

Before I conclude, I thank the staff for an excellent set of papers. With these remarks I wish the authorities success in their efforts.

Mr. Zhang F. made the following statement:

We are pleased to see that 1996 marked significant progress in Eritrea's economic development, as compared to that in 1995. Real GDP growth rate was nearly 7 percent in 1996 compared with 3 percent in 1995, while inflation fell from a double-digit level to a much manageable level of 3.4 percent. This has been achieved in spite of the negative impact of bad weather on agricultural output. I am in broad agreement with the staff's analysis and appraisal. And I shall briefly comment on some policy issues for emphasis.

What has made the overall picture still mixed is the large fiscal imbalance with the deficit accounting for 16 percent or 26 percent if you exclude grants, of GNP in 1996. As rightly pointed out by the staff, sustainable high economic growth cannot be realized and stability will be undermined if this situation remains unsolved. The staff has mentioned in particular a couple of weaknesses in government's budgetary management that has led to fiscal imbalance. They also laid down in a fairly detailed manner, a package of fiscal measures which requires prompt implementation so as to consolidate the fiscal performance for 1997 and beyond. It is encouraging to note that the authorities have taken necessary actions in this field.

Fiscal consolidation also serves as a prerequisite for a smooth and successful introduction of the national currency. We support the authorities' objective to sharply reduce the fiscal deficit and introduce a proven capacity to control domestic liquidity before the national currency was introduced.

I agree with the staff that the excess liquidity needs to be drained out of the banking system in order to build a solid base for the introduction of the national currency. To do so, the Bank of Eritrea should equip itself with adequate instruments such as reserve requirement and open market operations. The staff has also stressed the importance of developing monetary programming and an effective interbank money market. The authorities are encouraged to move ahead in a timely way to address these important issues.

On the issue of currency conversion, I am in favor of the authorities' plan to pursue it on a flexible basis subject to adequate preparations. It is extremely important to put in place certain legal and technical frameworks before the conversion. A number of key policy issues such as exchange rate policy, will also have to be addressed beforehand. As indicated by the authorities, Fund technical assistance is called for to help them prepare for the conversion. And I am sure the Fund's technical assistance is of great importance to the authorities and it will be a success.

Finally, we support the proposed decision and would like to wish the authorities every success in meeting the challenges ahead.

Mr. Kpetigo made the following statement:

The economic performance of Eritrea in 1996 was mixed with economic output growing by 7 percent and inflation decelerating. Impressive progress was made as regards reconstruction. However the large fiscal imbalance receded only modestly in 1996 as a reflection of a sharp decline in revenue and a substantial increase in expenditure. The continued reliance of both the government and the private sector on the banking system for their financial resources resulted in sharp expansion of broad money. These financial developments could delay the authorities' objective to introduce a new currency and establish their own monetary system.

In the fiscal sector, despite an expansionary stance, inflation was low due to increase in manufactured production and the rise in imports. As Mr. Morais pointed out in his statement, the authorities' determination to address the fiscal imbalance is encouraging and will help achieve sustainable high economic growth and stability. To achieve the fiscal discipline it is important that Eritrea establishes a comprehensive and formal budget that takes into account public revenue and expenditure with a view to prioritizing spending. For 1997, we welcome the authorities efforts to limit the deficit. Moreover, much work is still needed to widen the tax base and improve revenue collection. Government spending remains too high and a better system to monitor and control expenditure should be put in place. The recent comprehensive cutbacks in the civil service and in the army suggest that a lean, efficient and effective civil service is one of major objectives of the authorities. We encourage them to continue improving the fiscal situation in order to pave the way for the new monetary system.

As stated earlier, fiscal consolidation and appropriate monetary policy constitute prerequisites for introduction of the national currency. The authorities are right to worry about the appropriateness and soundness of conditions needed to put in place the new currency and we share their views as regards the introduction of the nakfa only after detailed preparation. One of prior action is to mop up excess liquidity in the banking system. Meanwhile, the authorities have already taken some prior actions such as maintaining financial discipline for the credibility of the new currency, and the unification of the official and preferential exchange rates for the birr in April. We agree that another initial step could be the reorganization of the trade regime associated with the simplification and rationalization of the tariff rates and concur with the staff recommendations in this area which could help improve the current tariff structure. To be properly conducted these actions call for the establishment of an efficient civil service with a solid administrative capacity. In this regards, Eritrea will need a technical assistance from the Fund and the World Bank, and from other institutions.

With these remarks I wish the authorities every success in their endeavor.

Mr. O'Brien made the following statement:

The Eritrean authorities must indeed be commended for a remarkable and sustained effort at economic rehabilitation and reconstruction, after such a long and destructive war for independence. I note that GDP growth more than doubled in 1996, while inflation was reduced from 11 percent in 1995 to 3.4 percent in 1996. While it is recognized that the coverage of the data on which these statistics are based is rather limited, nonetheless, noteworthy progress has been made. In addition, it is very encouraging to note that private investment in manufacturing and trading activities has 'surged' as this augurs well for the sustainability of the economic performance.

On the fiscal account, there is cause for some concern as the overall deficit, excluding grants, has only marginally been reduced to 26 percent of GNP and total expenditure remains well above 50 percent of GNP, in 1996, largely reflecting increases in the wage bill and capital outlays. I recognize, however, that the fiscal position, to a large extent, reflects the up-front costs of fiscal consolidation in which it appears that considerable progress has been made. The armed forces have been reduced by some 54 percent and the civil service by approximately one-third. In any jurisdiction, this is a remarkable achievement in such a short space of time, and must incur initially high costs. It is most encouraging also to note that the public sector reforms are not only about reducing numbers, but increasing efficiency and productivity. The reduction in the time for obtaining a license from six months to a half-hour speaks for itself. The authorities also appear to be moving with dispatch to rationalize state-owned enterprises.

I agree with the staff, however, that the current fiscal position is not viable or sustainable and that every effort must be made to contain expenditures and to improve and expand the revenue base. In this regard, the announcement that the 1997 budget would contain expenditure on wages at the 1996 level, adopt emergency measures to reduce the deficit, and introduce new tax measures are very welcome. Given that much of the expenditures incurred in 1995 and 1996 are not likely to be repeated in the same magnitudes, a significant reduction in the fiscal deficit seems achievable.

The launch of the Eritrean national currency, the nakfa, would be a most important watershed in the development of the monetary system. It is most heartening to note that the authorities are prepared to be flexible about the timing and would seek to ensure that conditions are favorable before the launch. I am concerned, however, about the staff advice, if I understand it correctly, that the parity of the new currency should be immediately and fully market determined. Given the fact that the banking system and the regulatory system are very much under developed, and there appears to be shortages of the necessary skills and competence, as well as the need for other fiscal and structural reforms to be put in place, I wonder whether this course would be in the best interest of Eritrea in the short to medium term. I would welcome staff comments.

Both the authorities and the staff concur on the need to improve the regulatory framework of the financial system and to open the banking system to foreign participation. The authorities indeed have begun moving in this direction. In this regard, also, the requests of the authorities for technical assistance should receive the best possible response from the Fund, and the staff should work closely with counterparts in the Bank.

I note with interest the comment in footnote 3 on page 9 of the staff report, that reserve deposits of the commercial banks were on-lent to the government by the Bank of Eritrea. Clearly, such action would have reversed any impact on liquidity in the banking system. Staff comments would be welcome.

I agree fully with the staff that the economic situation in Eritrea is fragile and the medium- to long-term prospects, although quite good, are predicted on substantial inflows from growth and concessional loans.

In addition, the urgency of the need for the authorities to effect the necessary trade and structural reforms to enhance export performance cannot be overstated. I would then encourage the authorities to continue their efforts to effect these reforms as quickly as possible.

Finally, it is worth noting that the authorities are very concerned with putting in place an appropriate safety net and have requested international donors to channel resources into areas of health and education. Also, while the foreign debt is not yet a serious problem, the decision of the authorities to establish a special debt management unit in the Ministry of Finance is both welcome and encouraging.

I wish the Eritrean authorities every success in continuing efforts to rebuild their economy.

Mr. Loevinger made the following statement:

This year is a critical year for Eritrea. It can either demonstrate that it has learned from the policy mistakes of others. Or, it can decide to experience these same mistakes first hand. As many other Directors have noted, current fiscal and monetary policies are simply not sustainable. We agree fully with staff's recommendations on the need to reduce the fiscal deficit quickly and limit central bank financing of the deficit.

In addition, the lack of a transparent budget not only has contributed to an unsustainable fiscal position but also raises serious concerns about governance. It would be useful if staff could elaborate on how much fiscal data is actually made public.

On another issue of governance, we want to raise, as we did last year, a disturbing trend that continues to receive little attention in staff reports. As the government's involvement in financial and commercial activities recedes, its place is being taken up, in some instances, by firms owned and controlled by the ruling party. These firms raise many of the same problems as state-owned enterprises, namely that many of their decisions are not made on purely commercial grounds. Furthermore, foreign investors may be deterred to the extent they believe there is not a level playing field. The fact is, in a one-party state, there may be little effective difference between state-owned and party-owned companies. We urge staff not to ignore this issue.

Mr. Gruber made the following statement:

The economic situation in Eritrea still presents a mixed picture. Economic recovery gained momentum; there was a marked deceleration in inflation, and there are the first signs of significant inflows of foreign private investment. Important measures have been taken to rehabilitate the infrastructure and to demobilize and reintegrate ex-combatants and refugees into civilian economic life. Worth mentioning are furthermore the measures undertaken to improve public sector resource management as well as the efforts of the authorities to prepare a comprehensive privatization program. However, the extraordinary outlays during the reconstruction phase made a big hole in the budget and led to a clearly unsustainable budget deficit as well as a rapidly increasing government domestic debt and excess liquidity in the banking system.

With this reconstruction phase largely completed, measures to substantially reduce the government's role in the economy and to reduce the budget deficit are now urgently needed. We share the staff's concern about the significant and unsustainable domestic and external financial imbalances. We urge the Eritrean government to introduce, as the highest priority, a policy package aimed at fiscal consolidation in 1997, as well as for the medium term, within the context of multi-year comprehensive and transparent budgets. We concur with the staff that revenue should be increased, expenditures reviewed and newly prioritized, and a public investment program should be formulated in order to achieve a fiscal deficit that can be financed in large without borrowing from the Bank of Eritrea. We welcome the measures already undertaken by the authorities in this respect.

Fiscal consolidation should be in place before the implementation of the new national currency. We concur with the staff that the credibility and value of the national currency will be determined, furthermore, by the exchange and trade regime adopted by the authorities. In this respect, the decision to adopt a market-based exchange rate upon introduction of the nakfa within a liberal exchange regime is welcome; and we join the staff in recommending the authorities to eliminate the remaining exchange restrictions on payments and transfers for current international transactions simultaneously. Finally, we encourage the authorities to ask for Fund technical assistance in monetary programming before the currency conversion.

The fact of being able to start nationhood without foreign debt is certainly an invaluable capital which has to be managed with great care. In this respect, we are assured by the Eritrean authorities' cautious approach in contracting new external debt and their intention to borrow only at highly concessional terms. In view of the considerable stock of external debt on a commitment basis, we welcome the government's intention to establish a unit at the Ministry of Finance for the proper management and monitoring of the public debt.

There is no doubt that Eritrea will have to rely, for quite some time, on external concessional assistance to finance its balance of payments needs. We believe that the technical, political and financial backing of a Fund arrangement could help the Eritrean authorities to strengthen their analytical and administrative implementation capacities, while providing the necessary resources to establish a more solid base for economic growth. At the same time, a medium term arrangement with the Fund would facilitate contributions of the donor community. We welcome in this respect the preparation of a National Policy Framework Paper (NPFP) to be discussed with the staff and the World Bank, which perhaps could form the basis for such an arrangement. We would welcome the staff's assessment on the Eritrean authorities' view on the possibility of a program in a not too distant future.

The staff representative from the African Department commented that the government realized the seriousness of the fiscal outturn in 1995 and 1996, and had reiterated that it would take measures in 1997 to reduce the fiscal deficit substantially. It had already taken some revenue measures in the administrative area, and the Fund was providing technical assistance to the customs department, which was improving customs valuation and collection of customs revenue. The staff had not yet been provided with details about the proposed tax measures, which would likely include an extension of the coverage of current indirect taxes and of some presumptive taxes.

The authorities had stated that most of the higher expenditures in 1995 and 1996 had been extraordinary outlays for reconstruction and relief payments—including demobilization, civil service reform, retroactive wage payments, and for families who had lost members in the 30-year war—amounting to 22–23 percent of GNP in 1996, the staff representative continued. While some of those expenditures would continue, most had been one-off or upfront payments. Even if the authorities did not take additional measures to reduce expenditures, there was significant scope for fiscal adjustment to occur. While capital expenditure was likely to be reduced to within the economy's absorptive capacity, it was unclear at present which projects would be phased.

Although many of the expenditures mentioned had been necessary, successful fiscal consolidation would require the authorities to establish a consistent and comprehensive budget, the staff representative stressed. A comprehensive budget would help the government to set expenditure priorities, which would be important, as the 1995 and 1996 fiscal outcomes indicated it would be imprudent for the government to finance all desirable expenditures. The government was realizing that fiscal discipline would not be possible until expenditure priorities were established. The staff hoped that the government had made a serious commitment to establishing a comprehensive budget, both to the Fund and to the World Bank—the Country Director and Vice President for the Africa Region of the World Bank had recently visited Asmara.

Lack of budgetary transparency in Eritrea was not symptomatic of corruption, the staff representative remarked. To most observers familiar with Eritrea, the country was relatively free of corruption. Related to the question of the public accounts was the govern-ment's willingness to extricate itself from playing a major role in public enterprises. As one Director had noted, the staff was concerned that privatization of enterprises into party-owned enterprises had not sent an appropriate signal to the private sector that the authorities were committed to full privatization of public enterprises. Nonetheless, the authorities were submitting 39 selected enterprises for international bidding. Additional efforts involving sufficient transparency and accountability would indicate that they were serious about their privatization program.

A number of Directors had pointed to the need to rebuild the capacity of the Central Bank of Eritrea, the staff representative noted. To that end, significant improvements had been made over the previous two to three years, and the government had made major efforts to recruit the most competent bankers available, including from the expatriate Eritrean community. However, as those efforts would likely prove to be insufficient, the authorities would need technical assistance, from the Fund and other institutions, to strengthen considerably their monetary and exchange rate operations. The authorities would likely request such technical assistance shortly, and the staff had indicated to them that it would be considered favorably by the Fund.

Eritrea was included in a common currency, but had relied for some time on a market-based exchange regime, the staff representative pointed out. Following the unification of the official and preferential exchange rates in April 1997, the most recent exchange rate fairly closely approximated the market rate, quoted by foreign exchange bureaus. The authorities were thus familiar with and capable of using market signals in exchange rate policy. Given the financial policy that the government had followed in the past and the need for substantial structural reforms, the staff had suggested that Eritrea rely on a market-based exchange rate regime following the introduction of the national currency, the nakfa, which the government was committed to doing.

The central bank did not have the ability to issue its own liabilities, as Eritrea was part of a currency union, the staff representative explained. With the commercial banks holding excess liquidity, the only means by which the central bank could have financed the massive fiscal deficit, amounting to more than Br2 billion in 1995 and 1996, was to have absorbed some of the excess liquidity within the banking system.

The staff had hoped that the policy framework paper that the authorities had been drafting would have been ready for discussion with the Article IV consultation mission, the staff representative recalled. While that paper had been delayed for a number of months, the authorities had assured the Fund and Bank staffs that the paper would be discussed with them once it had been completed. The staff believed that a balance of payments need was emerging, but the authorities had not yet requested a Fund-supported program, or given an indication when they would request such a program.

Mr. Morais said that he wished to thank the staff for its substantial work on Eritrea, which had greatly benefited the authorities. The latter looked forward to continuing cooperation with the Fund, including via technical assistance. Eritrea would certainly take Directors' comments into account when formulating policies.

Mr. Loevinger wondered whether the Acting Chairman could refer in his summing up to the need for a level playing field in the privatization process, particularly in relation to party-owned firms.

Mr. O'Brien, supported by Mr. Borpujari, commented that he favored a clear reference to the need for a transparent and level playing field in the privatization process with equality of opportunity but not a reference to party or other interests.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They welcomed the progress the authorities had made in economic reconstruction, and the fact that real growth had rebounded and inflation had eased in 1996. However, Directors expressed concern about the weak financial situation, which was due mainly to a large and unsustainable fiscal imbalance. A sharp expansion in net domestic credit, largely driven by the government's borrowing requirement, had contributed to an excessive increase in domestic liquidity and a marked deterioration in the external accounts.
>
> Directors stressed that disciplined financial policies and continued structural reforms were essential to lay the basis for sustainable growth. They urged the authorities to implement strong measures to bring the public finances firmly under control, particularly at a time when Eritrea was preparing for the introduction of a national currency. They emphasized the need to strengthen revenue performance and, more importantly, to curtail public expenditure. Directors called for steps to broaden the tax base, strengthen the tax and customs administration, contain the wage bill and other recurrent expenditure while improving the social safety net and prioritize public investments. They expressed concern about the lack of a comprehensive government budget, and stressed the importance of setting the government's fiscal stance within a medium-term context.
>
> Directors stressed that the planned introduction of a national currency should also be preceded by a mopping up of excess liquidity. They welcomed the recent enactment of a legal framework for the financial system, and the strengthening of the central bank's capacity to conduct independent monetary and exchange rate policies. Directors advised the authorities to take steps to develop the policy instruments required to effectively manage domestic liquidity and foreign exchange operations, and suggested that technical assistance should be sought from the Fund and World Bank. They also urged the authorities to promote the development of a competitive financial system through decontrolling interest rates and licensing private commercial banks and foreign exchange bureaus.
>
> In other key areas of reform, Directors welcomed the efforts being made to privatize the state enterprises, restructure the civil service, and ease the constraints on economic and social infrastructure. Directors encouraged the authorities to establish and maintain a transparent and level playing field, with equality of opportunity, in the privatization process and in the framework for conducting business; to simplify the tariff system; and to take steps to enhance

the efficiency of the financial system. They emphasized that far-reaching structural reforms would greatly facilitate private sector economic activity and enhance Eritrea's medium-term prospects.

Directors stressed the importance of strengthening the macroeconomic database.

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

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 1997 Article XIV consultation with Eritrea, in the light of the 1997 Article IV consultation with Eritrea conducted under Decision No. 5392-(77/63), adopted on April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/97/184, Eritrea maintains exchange restrictions, in accordance with Article XIV, Section 2, on the making of payments and transfers for current international transactions, comprising limits on travel, medical, and education allowances. The Fund encourages Eritrea to eliminate these restrictions as soon as possible.

Decision No. 11552-(97/78), adopted
July 28, 1997

7. REPUBLIC OF PALAU—MEMBERSHIP—COMMITTEE

The Acting Chairman noted that Executive Directors would have received the staff paper dealing with the application of the Republic of Palau for membership in the Fund. He proposed establishing an ad hoc membership committee, under the chairmanship of Mr. Toribio, to consider the application.

The Executive Directors accepted the Acting Chairman's proposal.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/77 (7/25/97) and EBM/97/78 (7/28/97).

8. GOVERNANCE ISSUES—ROLE OF THE FUND—GUIDANCE NOTE

The Executive Board approves the text of the guidance note on the role of the Fund in governance, as set forth in EBS/97/125 (7/2/97) and Supplement 1 (7/11/97).

Adopted July 25, 1997

9. 1997 ANNUAL MEETING—FORMAL NOTICE AND BRIEF AGENDA

The Executive Board instructs the Secretary to communicate the formal notice and brief agenda for the 1997 Annual Meeting by cable and by airmail letter to all Governors and Alternate Governors. (EBD/97/89, 7/18/97)

Adopted July 25, 1997

10. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/121 (7/24/97) is approved.

APPROVAL: January 13, 1998

REINHARD H. MUNZBERG
Secretary