January 26, 1998
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/67

10:00 a.m., July 2, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
A.D. Ouattara, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
M.-A. Autheman	H. Paris, Temporary
T.A. Bernes	C.X. O'Loghlin
B. Esdar	W.-D. Donecker
	N. Coumbis
	A. Giustiniani, Temporary
D.Z. Guti	
	D. Gotz-Kozierkiewicz
	H. Kaufmann, Temporary
A. Kafka	H.F. O'Brien
W. Kiekens	N. Goffinet, Temporary
	B.S. Newman
	M. Sobel, Temporary
A. Mirakhor	M. Daïri
	S. Rouai, Temporary
A.V. Mozhin	A. Vernikov
	A. Lushin, Temporary
G. O'Donnell	J. Shields
A.S. Shaalan	G.M. Iradian, Temporary
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	B. Andersen
G.F. Taylor	O. Kwon
	C.M. Gonzalez, Temporary
	M.A. Cilento, Temporary
J.J. Toribio	T. Brizuela, Temporary
	C.A. Lucenti, Temporary
J. de Beaufort Wijnholds	L.B.J. van Geest, Temporary
K. Yao	K. Kpetigo, Temporary
Y. Yoshimura	H. Ono
Zamani, A.G.	S. Joyosumarto
Zhang Z.	Han M.
A.G. Zoccali	N. Eyzaguirre

R.H. Munzberg, Secretary
W.S. Tseng, Acting Secretary
P. Cirillo, Assistant
M.M. Cuc, Assistant
D.J. de Vos, Assistant

Also Present

IBRD: M.E. Haddad, South Asia Regional Office; R. Morales, Cofinancing and Project Finance Office; J. D. Shilling, Operations Policy Office. African Department: A. Basu, Deputy Director; P.A. Acquah, C. A. François, A. Tahari. Asia and Pacific Department: A. Chopra, C.V.A. Collyns, D.J. Goldsbrough, M. Muhleisen, D.J. Robinson, M.B. Rose, H. Shishido, D. Tzanninis. European I Department: M.C. Deppler, Director; M.J. Fetherston, H.M. Flickenschild, N.A. Koliadina, T.D. Lane, J. Mueller, D.J. Ordoobadi, R.S. Teja. European II Department: D.J. Donovan. External Relations Department: S.J. Anjaria, Director; M.E. Hansen, H.P. Puentes. Fiscal Affairs Department: L.P. Ebrill, R. Hemming, P. Shome. IMF Institute: S. George. Legal Department: F.P. Gianviti, General Counsel; W.E. Holder, Deputy General Counsel; H. Elizalde, J.L. Hagan, H.V. Morais. Monetary and Exchange Affairs Department: M. Guitian, Director; R.B. Johnston, M.D. Knight, B.J. Laurens. Policy Development and Review Department: J.T. Boorman, Director; J. Ferran, Deputy Director; O. Havrylyshyn, Deputy Director; B. Christensen, L.D. Dicks-Mireaux, T.W. Dorsey, M. Fisher, K.H. Lee, A. Singh, S.K. Wajid. Research Department: Z. Chen, D. Folkerts-Landau, P.R. Masson. Secretary's Department: P. Gotur, A. Mountford, S.L. Yeager. Statistics Department: C.S. Carson, Director. Treasurer's Department: D. Williams, Treasurer; S.T. Lurie, P.R. Menon. Office of the Managing Director: J.A.P. Clément. Advisors to Executive Directors: M.A. Ahmed, O.L. Bernal, S.S. Farid, P.M. Fremann, A. Guennewich, J. Jonáš, J.M. Jones, R. Kannan, M.F. Melhem, H. Mori, J.-C. Obame, H. Ogushi, Y. Patel. Assistants to Executive Directors: H.I. Abdul Rahman, N.R.F. Blancher, J.G. Borpujari, M.A. Brooke, K. Brownlee, J. Chelsky, H.W. Cocker, A.L. Coronel, D.A.A. Daco, C.K. Duenwald, M.H. Elhage, L. Fontaine, D. Fujii, S. Fukushima, D. Giga, J.K. Honeyfield, Huang X., O. Issaev, M. Kell, J.P. Leijdekker, M.Z. Maatan, S.D. Melese-d'Hospital, F. Mercusa, D. Merino, M. Nemli, L. Palei, A.R. Palmason, L. Pinzani, Qi J., G.P. Ramdas, O. Schmalzriedt, S. Simonsen, Song J., Y. Tahara, V. Trivedi, R.P. Watal, E.L. Zamalloa, Zheng H., Zubir bin Abdullah.

1. THAILAND—REPORT BY STAFF

The staff representative from the Asia and Pacific Department made the following statement:

> We were informed last night that the exchange rate system in Thailand will henceforth be a managed float, with the value of the baht determined by market forces, and the Bank of Thailand intervening in the foreign exchange market from time to time. The baht depreciated by the end of the day to about B 28 to the U.S. dollar—a depreciation of 8.2 percent from its previous closing—in the onshore foreign exchange market, and about B 29.2 to the U.S. dollar—a depreciation of 16.9 percent—in the offshore market, with unusually high bid/offer spreads.
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> While we do not yet have details of the precise mechanics of the new system, senior Bank of Thailand officials have been quoted as saying that they would try to keep the exchange rate within an unpublished band centered on a new, wider currency basket, and that a reference rate would be published as a guide to commercial banks. The announcement noted that, while the authorities' recent measures to contain speculation had been successful, the confidence of domestic business in the fixed exchange rate policy had continued to weaken.
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> To support the new exchange rate policy, the Bank of Thailand has raised the bank rate from 10.5 percent to 12.5 percent. Last week, the Bank of Thailand suspended about 16 troubled finance companies as part of an emerging package to address financial sector difficulties. The recently imposed capital controls remain in place. The authorities have also stated that, in order to alleviate any negative effects on debt servicing from movements in the exchange rate, they are prepared to consider a number of options for businesses suffering from exchange losses, including financing facilities for priority economic sectors.
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> The stock market rose 7.8 percent. There are reports that market-determined domestic interest rates rose sharply.
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> The authorities have requested technical assistance from the Fund on, inter alia, the restructuring of financial institutions and the conduct of monetary policy under a flexible exchange rate system.
>
> These are all steps that are consistent with the staff's policy advice and the thrust of the recent Board discussion. So is the strengthening of the budget announced recently. Before an assessment can be made of the need for any additional measures, the staff will need to obtain more details from the authorities.
>
> On other developments in the region, there was some pressure in other neighboring countries, in the Philippines and in Malaysia, and small net sales were made by respective central banks.

Mr. Shaalan inquired about the effect of the increase in interest rates and the depreciation of the baht on Thailand's commercial banks.

The staff representative from the Asia and Pacific Department indicated that the staff would be discussing that and other issues with the authorities in the coming days. At present, the staff did not have any additional information on the state of the financial sector beyond the staff report, which had been discussed recently by the Board.

The Acting Chairman said that the authorities' request for assistance indicated that they themselves would like to have a clearer picture of the situation in the commercial banking sector.

Mr. Toribio asked the staff to explain the meaning of the reference rate for the baht. Were the authorities going to intervene in the market at that rate?

The staff representative from the Asia and Pacific Department replied that the staff did not know at present—the details of the system would be a central subject of the staff's discussions with the authorities.

Mr. Esdar inquired whether the caps on interest rates introduced to protect financial institutions would remain intact after the increase in the bank rate.

A second staff representative from the Asia and Pacific Department said that the objective of caps on interest rates had been to prevent a rise in interest rates that would result from competition among promissory notes issued by finance companies in financial distress. Those caps would be retained for the time being, and it was not clear whether the authorities planned to make any changes in the very near future.

Mr. Shields inquired whether the Fund would make a public statement about Thailand's situation.

The Acting Chairman indicated that a decision had not been made yet whether or not to issue a statement. It might not be inappropriate to issue a statement now, because the authorities had in fact moved in the right direction in every area that the Fund had discussed with them. A statement could acknowledge that the policy changes moved in the right direction and reflected the discussions with the Fund for the past few weeks. At the same time, the Fund, in cooperation with the authorities, was making a fuller appraisal.

Mr. Yao inquired whether the authorities' desire to protect strategic sectors implied a move toward a dual exchange rate system. If so, was that the best way of addressing the problem of those sectors? What sectors would received support?

The first staff representative from the Asia and Pacific Department replied that the staff had not obtained detailed indications from the authorities on that question. However, the issue would be discussed with the authorities.

The Acting Chairman added that the financial system, rather than any particular industrial sector, was the object of the authorities' concerns.

Mr. Zoccali inquired about financial facilities to be implemented for borrowers affected by the exchange rate depreciation—what would be the modalities of such facilities and their eventual fiscal implications?

The second staff representative from the Asia and Pacific Department stated that the details of the measures were not available. The authorities had indicated that they were prepared to consider measures, such as protection of prices of consumer necessities, tax deductions for businesses suffering exchange losses, and financing facilities for priority economic sectors.

Mr. Shields inquired about the relative importance of the two market rates—offshore and onshore—and whether the disparities between the two were likely to increase or decrease.

The second staff representative from the Asia and Pacific Department said that the onshore rate was the more important of the two rates. It applied to all trade and investment transactions, which at the moment were more important than the others. It was extremely difficult to tell how long the market segmentation could be maintained. At some point, the differential would likely produce incentives for over- and underinvoicing, which would be reflected in the current account, but the staff had no evidence of that occurring as yet.

The Acting Chairman asked whether the switch to floating had produced a fundamental shift in relations between the two markets.

The second staff representative from the Asia and Pacific Department replied that the two market rates had reversed—with the offshore rate becoming weaker than the onshore rate after the introduction of the floating exchange rate. However, it was difficult to draw strong conclusions on the basis of one day's rather confused trading. For the time being, the two markets remained segmented.

Mr. Zamani made the following statement:

> The staff and my office were alerted early last night about the exchange rate policy change. We are still trying to obtain answers to some of the questions that Directors have been asking today: for example, the extent of financial institutions' problems and the assistance to be provided to them. So far, the authorities have mentioned about 16, but the options remain open as the decision to float the exchange rate was quite momentous.
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> The other question was whether the offshore and the onshore exchange rates will merge. The staff and my office will be trying to get answers and will inform the Board as soon as we can.
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> As to whether a press statement is required to be issued by the Fund, the Governor of the central bank has stated that the country is seeking technical assistance from the Fund as well as from the Reserve Bank of Australia. But it has to be seen in the next several days as to whether the Fund should respond or not. I would also add that, as Thailand has taken the decision that the Board has advised them to take, the Board should support Thailand's request for assistance from the Fund.

The Acting Chairman remarked that the Fund had been in touch with the staff member who would likely be visiting Thailand at the end of the Philippine mission. In addition, the Fund was moving quickly to provide the technical assistance requested by the Thai authorities. The Fund had also contacted the World Bank to ascertain whether a joint team could examine some of the pressing financial sector issues. The Board would be kept apprised of any new developments.

2. CAPITAL MOVEMENTS UNDER AN AMENDMENT OF THE ARTICLES OF AGREEMENT—CONCEPTS OF "INTERNATIONAL CAPITAL MOVEMENTS" AND "RESTRICTIONS"

The Executive Directors continued from Executive Board Meeting 97/66 (6/30/97) their consideration of a staff paper on capital movements under an amendment of the Articles of Agreement—concepts of "international capital movements" and "restrictions" (SM/97/146, 6/10/97; and Sup. 1, 6/25/97).

The Acting Chairman made the following concluding remarks:

> We have had a very useful discussion on this important topic and I would like to thank Directors for their valuable contributions. As I indicated in my statement prior to the meeting, it is understood that Directors and their authorities will need ample time to consider all aspects of these complex issues and that Directors' views on the issues discussed are of a preliminary nature and are without prejudice to their final position. I would also note that, at this early stage of the discussion of an amendment, a number of Executive Directors did not wish to address all of the issues raised by the staff, and the following concluding remarks should be viewed in this light.
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> Most Directors expressed the view that, to the extent possible, the methodology that has guided the application of the Fund's existing jurisdiction should be used in the design of its prospective jurisdiction over international capital movements. A few Directors noted, however, that since the application of jurisdiction in this area will involve the exercise of considerable judgment, we should not rule out examining other procedures and, in particular, the experience of other international agreements in the area of jurisdictional findings. Moreover, several Directors expressed the view that the extension of the Fund's jurisdiction could provide an occasion to review the effectiveness of Fund sanctions.
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> Most Directors supported extending Fund jurisdiction over a broad range of financial assets. Many Directors also believed that, since outward investments were generally regulated for balance of payments and macroeconomic reasons, it would be appropriate for the Fund's jurisdiction to also extend to outward direct investment, including the acquisition by residents of real estate abroad. However, with respect to the acquisition by residents of foreign intellectual property rights, a few Directors questioned whether such transactions were sufficiently related to the Fund's mandate.
>
> With respect to the treatment of inward direct investment, most Directors felt that such transactions should fall outside the Fund's jurisdiction

in all respects. Several Directors expressed the view, however, that discrimination among investors of different members should be precluded and that, for purposes of transparency, all members should notify the Fund of restrictions on inward direct investment. A few Directors questioned the exclusion from the Fund's jurisdiction of inward direct investment in real estate. It was recognized that these issues will be discussed in detail at the next meeting.

Regarding the criterion that would be used to determine when a measure is a "restriction," most Directors expressed support for the use of the criterion of discrimination between domestic and international transactions. A few Directors proposed that, in addition, consideration be given to treating discrimination among nonresidents as a restriction. While most Directors agreed to use the definition of "international" outlined in the staff paper, a few questioned the "asset location" criterion and requested further clarification.

Regarding the application of the criterion of discrimination, a number of Directors felt that it would be appropriate for the Fund to cover not only explicit discrimination, but also discriminatory authority and implicit discrimination. Regarding discriminatory authority, these Directors supported an approach in which a measure giving the relevant agency the authority to discriminate would constitute a restriction, even in the absence of any evidence of discriminatory implementation. Regarding implicit discrimination, a few Directors expressed reservations as to its inclusion and a number of Directors emphasized that, if it were to be included, it should be implemented cautiously, bearing in mind that the judgmental nature of the finding would require greater staff and Board involvement. In this regard, and more generally on the implications of the amendment, the staff was requested to elaborate on any resource implications.

Directors were divided as to the treatment of restrictions imposed by subnational entities of members, including states and provinces. A few Directors felt that no exception to the general principles should be made in this regard. Others, however, felt that the amendment should take into consideration the particular circumstances of members whose constitutions did not give the federal government full authority over the regulation of the transactions that would fall within the Fund jurisdiction. It was agreed that further discussion would have to take place on this subject.

Regarding proprietary actions, many Directors expressed the view that the treatment of these measures under its existing jurisdiction should be extended to the amendment. A few Directors felt, however, that further consideration should be given to bringing sovereign defaults within the Fund's jurisdiction. It was noted that further consideration would be given to this issue in subsequent papers.

There were differences in views as to whether jurisdiction should continue to cover restrictions imposed for reasons unrelated to macroeconomic and balance of payments management. While many Directors felt that such restrictions were appropriately dealt with under Fund approval policies, others felt further consideration would need to be given to alternative approaches particularly in the area of prudential and national security measures. It was agreed to revisit this issue after the discussion of approval policies and transitional arrangements.

A number of Directors noted that, given the progress that was being made on the amendment, further consultation should be undertaken with other interested organizations, particularly the WTO, to avoid conflicting obligations. As was noted by the staff during the meeting, this consultation has already begun on a technical level and will expand as further work is done on the amendment. In that regard, several Directors suggested that a representative of the WTO be invited to the Executive Board meeting that will include a follow-up discussion on the above issues.

As noted above, a number of the issues identified above will be discussed during the next meeting on the proposed amendment (EBM/97/72, 7/15/97). Other outstanding issues will be taken up in a subsequent meeting (EBM/97/87, 8/26/97; and EBM/97/88, 8/27/97).

3. ENHANCED STRUCTURAL ADJUSTMENT FACILITY—USE OF RESOURCES FOR COMMERCIAL DEBT- AND DEBT-SERVICE-REDUCTION OPERATIONS—FURTHER CONSIDERATIONS

The Executive Directors continued from Executive Board Meeting 97/64 (6/25/97) their consideration of a staff paper on the use of the resources of the Enhanced Structural Adjustment Facility (ESAF) for commercial debt- and debt-service-reduction operations (EBS/97/94, 6/4/97; and Sup. 1, 6/30/97; see also EBS/97/42, 3/11/97).

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

This statement explains the legal difficulties of implementing the proposal to limit the use of ESAF resources for financing debt- and debt-service-reduction (DDSR) operations only to countries eligible for assistance under the Heavily Indebted Poor Countries Debt Initiative (HIPCs) within the framework of the existing ESAF Trust. It also indicates how such a proposal, if approved, could be implemented either through a suitable amendment of the 1987 ESAF Trust Instrument or through the establishment of a separate new facility.

The basic legal difficulty with the proposal is that it would be contrary to the principle of uniformity of treatment among ESAF-eligible members. This principle may be compared, but on a limited scale, with the general principle of uniformity of treatment for rights and obligations under the Articles of Agreement. This means: First, on the part of the Fund, that it must act in a manner that does not discriminate among its members; that is, its treatment of members must be uniform and comparable, allowing no preference in favor of any one member or group of members. Second, on the part of the member, it means that if it satisfies the objective criteria for receiving assistance set out in the Articles of Agreement or under any special policies adopted thereunder, it would be entitled to uniform access to the use of resources under the same conditions as any other member. The principle of uniformity of treatment is also implicitly recognized in the relevant provisions of the ESAF Trust Instrument. Thus, when the Fund transferred resources from the Special Disbursement Account (SDA) to the ESAF Trust pursuant to Article V, Section 12 (f)(ii) upon the establishment of the ESAF Trust in 1987, it established "special terms" for the use of ESAF resources for "developing countries in difficult circumstances," and for this purpose was authorized to take into account the level of per capita income. As applied in this case, the principle of uniformity of treatment means that all members falling within this classification or subgroup of ESAF-eligible members must be treated uniformly by the same special terms established.

The sole criterion (i.e., "special terms") established in the ESAF Trust Instrument for access to ESAF resources is that a member has a "protracted balance of payments problem." The determination of whether a member has a "protracted balance of payments problem" is to be made by the Fund, in its capacity as Trustee of the ESAF Trust. In making this determination, the Fund would look, among other things, at the member's external debt liabilities and how these liabilities affect its balance of payments position. In other words, the member's external debt situation is one of several elements to be considered in making a balance of payments assessment. It is not a separate criterion. Therefore, any proposal to limit ESAF financing for DDSR operations to a subgroup of ESAF-eligible members—for example, HIPCs, African countries, or sub-Saharan African countries—to the exclusion of all other ESAF-eligible numbers would be inconsistent with the principle of uniformity of treatment that should apply to all ESAF-eligible members with respect to availability and use of resources of the facility. Specifically, the proposal would have the effect of disqualifying all other ESAF-eligible members from receiving similar support, even though these other members may have a "protracted balance of payments problem," on the basis of a consideration that is extraneous to the Instrument—that is, that those members are not HIPCs.

In effect, the proposal would materially change the eligibility criterion under the ESAF Trust. The ESAF Trust was specifically established to provide loans on concessional terms to all low income developing members. There is nothing in the ESAF Trust Instrument that would permit the Fund to discriminate between one group of low income developing members and another. In fact, the Instrument established eligibility for assistance by reference to members on the list annexed to Decision No. 8240-(85/56) SAF, and states that all these members shall be eligible for assistance from the Trust.

Moreover, there is at present no legal impediment whatsoever under the terms of the ESAF Trust Instrument for any ESAF-eligible member to use the proceeds of its ESAF loans to finance DDSR operations. The reason the Fund has not financed DDSR operations in the past is that several Executive Board members had previously expressed reservations about the use of concessional resources to finance such operations in respect of commercial bank creditors.

The proposal, if implemented, would effectively result in the creation of two categories of ESAF-eligible members with different entitlements and different terms by placing a new restriction on the access to, and the use of, ESAF resources by non-HIPCs. Specifically, the Fund would not be able to consider financing of DDSR operations as a component of the size of a member's balance of payments need in determining access to ESAF resources for the non-HIPCs. Thus, resources initially transferred from the SDA or contributed by donors and lenders to the ESAF Trust for all ESAF-eligible countries would no longer be available on the same terms and conditions to all ESAF-eligible countries.

The only possible way of implementing the proposal would be to create a new subfacility for HIPCs. The creation of this new subfacility for a limited group of ESAF-eligible members would have to be treated as a new use of SDA resources and a transfer of resources outside the ESAF. As the decisions to transfer SDA resources to the ESAF Trust required an 85 percent majority of the total voting power (pursuant to Article V, Section 12(f)), the adoption of the proposal would similarly require a decision of the Fund by an 85 percent majority of the total voting power. Furthermore, in order to become effective, such a decision would also require the consent of all ESAF contributors.

Mr. Bernes made the following statement:

Let me begin by expressing my appreciation for the patience and interest expressed by my fellow Directors in supporting this chair's efforts to address a number of concerns raised with respect to the use of scarce ESAF resources to finance commercial DDSR operations for low-income countries. The issue is clearly more complicated than it appeared at first sight, and I am pleased that we have not allowed ourselves to make any hasty judgments or decisions on the staff's proposal. I am also appreciative of the detailed consideration of this chair's proposal provided by the staff, as well as the acknowledgment of a number of downside aspects of allowing more demands to be placed on the ESAF at present.

The staff has articulated problems associated with seeking to limit eligibility for ESAF resources for commercial DDSR operations. While I am not entirely convinced that it has provided an exhaustive search for alternative means of containing the costs of eligibility, I appreciate the need not to tie up too many more staff resources on an issue with only moderate cost implications while other, larger policy considerations are placing heavy demands on our time. Therefore, rather than addressing head-on the concern the staff voiced with respect to my proposal for a limitation on access to ESAF resources for commercial DDSR operations, it would be more instructive to take a step back and clarify what it is we are trying to achieve. I see two basic objectives which I think we can all agree upon, the first being to minimize the negative impact on the level of a self-sustained ESAF and the availability of resources for the HIPC Initiative, and the second being to ensure that low-income countries undertaking commercial DDSR operations which meet the relevant criteria for IFI involvement have available financing on appropriately concessional terms.

At the same time, it is highly ironic that the World Bank staff has revealed recently that it is no longer willing to participate in the proposed DDSR operations for Vietnam without Fund participation through ESAF. While I would be open to other interpretations, at this point in time I see no other explanation for the World Bank's change of heart other than that they currently envisage the availability of concessional resources from the Fund, and are therefore seeking to reduce the use of their own concessional resources by substituting some of our concessional resources. As the staff has recently pointed out, this would have the effect of lowering the overall concessionality of the multilateral financing for Vietnam's commercial DDSR operation—to the clear detriment of Vietnam. I am therefore very pleased to note Fund management's resistance to this new World Bank demand for Vietnam, and I would encourage us to maintain this posture.

The irony in making ESAF resources available for commercial DDSR operations is that it in fact risks harming the very countries that we portend to assist, given that there is no additionality associated with the Fund's participation in the financing. This may seem counterintuitive to those Directors in this Board who have viewed the question as simply opening up a new source of concessional financing for low-income countries to draw upon in undertaking commercial DDSR operations. Unfortunately, this is not the case. In our effort to assist, we may indeed risk doing more damage than good. In particular, we continue to view this institution's actions on this issue in isolation from those of the World Bank. I think it does not require any great leap in logic to realize that what is the case with Vietnam may also be the case for other low-income countries which might undertake commercial DDSR operations using multilateral resources in the future; that is, by making it possible for ESAF resources to be used for commercial DDSR operations, we run the risk of substituting our less concessional the Fund resources for IDA's more concessional resources. The difference is not trivial; the grant element of IDA resources is significantly higher than for ESAF resources.

This leads us to the assertion of the World Bank staff that some formal burden-sharing arrangement exists that demands ESAF resources be used alongside IDA resources for commercial DDSR operations. I soundly reject this position, for a number of reasons. First, if there is a formal burden-sharing policy, it would need to have been approved by the Bank's Executive Board. As the World Bank staff indicated at the previous discussion of this issue (EBM/97/64, 6/25/97), the Bank Board has not been consulted on this issue. Therefore, as my chair has stated before, the burden-sharing assertion is Bank management's preference and not Bank policy. We should keep this in mind in assessing how seriously to take the alleged burden-sharing requirement.

Second, the World Bank has provided balance of payments assistance and structural adjustment credits to low-income countries without any formal burden-sharing arrangement with the Fund other than the existence of a Fund program. I see Bank involvement in a commercial DDSR operation for low-income countries as no different. Indeed, until recently, the staff of the Bank shared my assessment.

Third, ESAF and IDA resources are essentially donor resources. I believe the Bank staff has a moral obligation to listen to the desires of donors in deciding what to do with these resources. If donors are not troubled by the absence of complementary action by ESAF, perhaps in light of relative issues of scarcity of concessional resources between the two institutions, the Bank should withdraw its demand for ESAF resources.

Finally, and perhaps more relevant, we know that the Bank has provided grant allocations from the IDA Debt Reduction Facility to low-income countries for commercial DDSR operations with no complementary action by the Fund. It does not seem consistent that they now demand formal burden sharing when the use of general IDA resources are involved. For these reasons, I believe we can challenge the Bank staff's assertion that the Fund needs to provide ESAF resources in the context of the proposed operations.

My proposal to limit the use of ESAF resources was made in an attempt to forge a compromise between a blanket use of ESAF for commercial DDSR operations and no use of ESAF whatsoever. What the current discussion will show is whether or not the Board thinks that such a compromise is viable. For my part, and on behalf of my Canadian authorities, the fact that the original proposal—in light of the Bank staff's recent change of heart—would likely lead to less, and not more, concessional financing for low-income countries undertaking DDSR operations suggests that we serve none of our overarching objectives in proceeding with the original proposal. If therefore the consensus of the Board is to approve the proposed decision, I, on behalf of my Canadian authorities, must record my abstention from such a decision.

Mr. Al-Tuwaijri made the following statement:

At last week's meeting on this matter, like several other Directors, I expressed concern over the implications of an open-ended access for all ESAF-eligible countries. I therefore appreciate the staff suggestion for periodic reviews of ESAF resource use in DDSR operations. I also welcome the understanding that the proposed policy on ESAF use for commercial DDSR operations will be carried out in a way that would contain costs well within the estimates the staff made in the last Board Paper.

I am, however, still unclear on the burden sharing issues with the Bank. Specifically, I read differing messages from Paragraphs 6 and 7 of today's paper.

Paragraph 6 identifies the Fund as a residual player by stressing that it "might be relevant" in some cases and "would take place only in the context of IDA financing, and after all other financing, including donor financing and use of the member's own resources have been explored."

Yet, in Paragraph 7, the staff seeks the Board's guidance in the case of Vietnam because of another criterion, i.e., lack of assurance on whether the

Bank will go ahead with the DDSR operations without Fund support. This is a concern as the request opens the possibility of a shift in Fund participation from residual to standard basis. I will appreciate staff views on that possibility.

With these remarks, I support the proposed decision.

Mr. Yoshimura made the following statement:

As I stated at the previous Board discussion on this subject, ESAF resources should be used only in a highly prudent manner, given their scarcity. In this respect, I support the spirit of the proposal by the Canadian chair, though the staff has explained that the adoption of this proposal would require virtually the creation of a new facility, by an 85 percent majority of the total voting power. If the necessary support can be obtained in the Board, I am prepared to consider supporting the creation of a new facility. Unfortunately, however, it seems unlikely that the proposal by the Canadian chair will attract sufficient support. If the Board decides to support the staff's proposal, I reiterate the need for prudent use of ESAF resources. In line with the views expressed in EBS/97/94 Supplement 1, the staff's proposal should be carried out in a manner that results in costs to the ESAF that will remain well within the financial parameters presented originally by the staff in EBS/97/94.

Given that it has been assumed until recently that Vietnam would finance its DDSR operation with a combination of an IDA DDSR credit and its own resources, I can support the staff's position not to provide ESAF resources for this DDSR operation. Japan's Executive Director at the World Bank will adopt the same position on this issue.

My authorities believe that the general policy aspects of burden sharing between the Fund and the Bank should first be discussed in the Board of the Bank, and that the staff of the Bank should not prejudge this discussion. Such a discussion should have preceded the discussion in the Board of the Fund on the use of ESAF resources for DDSR operations. While I neither wish to prejudge the discussion in the Board of the Bank, the Bank management's assertion that the Fund needs to provide ESAF resources before the Bank can provide IDA resources for DDSR operations is inappropriate, for the reasons provided by Mr. Bernes, including the fact that the IDA Debt-Reduction Facility has been used previously with no complementary action by the Fund.

Mr. Giustiniani made the following statement:

Even though my chair appreciates the efforts of the staff and the Board to find a viable solution to a problem highlighted by Mr. Bernes, the issue has turned out to be more complicated than expected. I will reiterate the position of my chair, which has had strong reservations about the staff's proposal from the start. The proposal represents a significant departure from the guiding principles underlying the use of ESAF resources, in that it suggests the use of ESAF resources for a highly specific balance of payments problem, which is nonstructural in nature, and which implies additional use of resources beyond the normal access limits. All of these factors have led, if not to the establishment of a new policy, at least to the establishment of a special lending window within the ESAF. I regret that EBS/97/94, Supplement 1, does not address the latter issue, which Mr. Grilli raised at the previous Board discussion.

My chair remains convinced that the Fund still needs to request the consent of all ESAF creditors before proceeding with the staff's proposal. Even if such were not considered a strict legal requirement, approval by all creditors is a necessary precondition for modifying the principles underlying the ESAF. Moreover, as Mr. Bernes has underscored, the mere discussion of the possible use of ESAF resources for DDSR operations has induced perverse reactions in other institutions, which reinforces my chair's original concerns. While my chair saw some merit in the proposal of Mr. Bernes at the previous Board discussion, this proposal is unlikely to attract sufficient support in the Board. In these circumstances, my chair cannot support the staff's proposal.

Mr. Donecker made the following statement:

I do not want to repeat all the arguments against a possible use of ESAF resources for DDSR operations today that other colleagues and I already mentioned at our meeting last Wednesday.

Suffice it to say that they remain valid and are further strengthened by what Mr. Bernes, Mr. Yoshimura and, Mr. Giustiniani have just said!

Against the background of scarce ESAF resources, in particular in view of the so far clearly insufficient and disappointing bilateral ESAF pledges, it appears simply imprudent for the Fund to allow for the unlimited use of ESAF resources for commercial DDSR purposes.

This would not only encourage World Bank staff to shift more of these operations our way, with the bizarre effect—as Mr. Bernes rightly said—that the country in question is likely to get a worse deal than if we insisted on the present distribution of responsibilities between Fund and Bank.

For this reason, we certainly also support staff's opposition with regard to debt relief for Vietnam.

Moreover, an open ended Fund participation in such bail-out operations, in all likelihood, would raise the market price for such debts, thereby reducing the possible discount the country concerned can achieve with such buy-backs and thus raising our and IDA's cost as well. In addition, such ESAF use most likely would also weaken the agreed burden sharing under the HIPC-initiative to the detriment of the Fund—especially if such support leads to discounts that are lower than those provided by multilateral creditors and the Paris Club for HIPC-qualified countries. So far, the IDA Debt Relief Facility only participates in such DDSR operations if a deep discount of, on average 80–90 percent, on such commercial debt can be achieved.

Is this really what this Board wants to achieve at the additional cost of, at the least, irritating some major donor countries and of putting the interim and permanent ESAF at risk? In our view the ESAF was established to directly support macroeconomic and structural reform efforts.

However, if the broad majority of the Board still wants to go ahead with such a project, in spite of all those concerns, and I do not see much support for such a move so far today this chair, in the spirit of compromise, will not stand in the way of such a scheme if the following three points were included in the amendment of the existing Board understanding on the use of ESAF for such operations on the basis of a broad Board consensus.

Point 1: As the staff has mentioned already in its supplementary paper, such ESAF use should be only subsidiary, to IDA debt relief and other IDA assistance, to the use of the country's own financial reserves and to other bilateral assistance, i.e., rather as a "last resort" .

From this follows Point 2, that in each individual case, the use of ESAF resources for such purposes could only be a lesser amount or at a maximum equal to IDA's concessional assistance for this purpose. Particularly, in the case of a country that qualifies for HIPC assistance, an adequate burden sharing among private and public creditors must be ensured, i.e., normally at least a discount of 80 percent.

Point 3: The Board would agree that the total commitment of ESAF resources for such operations would be irrevocably limited to a maximum amount of $150 million, i.e., a "cap" amount that, it is to be hoped, will not be fully needed.

This is the absolute minimum number of safeguards the Board, in our view, must insist upon in order to protect the purposes and the viability of the ESAF facility. This would also limit the negative effects of such a scheme on the proper division of labor between Fund and Bank and would guarantee the maintenance of a fair burden sharing under the HIPC.

I do hope that a broad-based consensus to establish such a concrete and irrevocable cap on the total amount of ESAF use for such DDSR operations can be reached in this Board right at the outset.

Otherwise, we will not be able to support such use of ESAF resources.

Mr. Joyosumarto made the following statement:

The position of this chair on the use of ESAF resources for commercial DDSR operations remains unchanged. While we still have some reservations, we can support this proposal as it provides the needed additional support for low-income countries undergoing intensive economic restructuring.

With regards to Vietnam, it is our understanding that IDA resources alone are insufficient to contribute significantly to the costs of Vietnam's

> commercial DDSR operations. We also understand that IDA is not seeking a complete substitution of IDA resources with ESAF resources as would appear to be implied by the Fund staff. What IDA apparently have in mind, is some sort of burden-sharing arrangement where concessional resources are provided jointly by IDA and ESAF for Vietnam's DDSR, with the balances of financing required coming from Vietnam's own resources as well as from bilateral donors. This is basically similar to the terms that Fund staff have proposed for the use of ESAF resources for DDSR operations. As staff has correctly pointed out, Vietnam is clearly eligible for such assistance if the proposal is approved, and we would like to urge the Board to support the inclusion of Vietnam in the use of ESAF resources for commercial DDSR operations.

Mr. Yao remarked that Mr. Bernes had presented a convincing argument for limiting the use of ESAF resources for DDSR operations to countries qualifying for the HIPC Initiative, given scarce ESAF resources. However, as explained by the staff, his proposal would require either the establishment of a separate facility or an amendment of the 1987 ESAF Instrument; it had not been clear whether or not Mr. Bernes favored either of those requirements. His own authorities continued to believe that the use of ESAF for DDSR operations was consistent with the spirit of the 1987 ESAF Instrument.

Mr. Autheman commented that he agreed with Mr. Donecker's first two points, that any Fund contribution to DDSR operations should be subsidiary to IDA assistance, including debt relief, the use of a country's own resources, and other bilateral assistance; and that the use of ESAF resources should be less than, or, at most, equal to, the IDA contribution. However, his third suggestion, that the Board irrevocably cap the use of ESAF resources for DDSR operations, was counterproductive. If the Board agreed to such a cap, that cap would effectively become a financing floor to IDA. It would weaken the Fund's stance regarding Vietnam, for example, because the Bank could argue strongly that, as the Fund had set a cap on the use of ESAF resources, those resources should be available a priori to support Vietnam. It reminded him of the dynamic in budgetary discussions in which one party believed that its position had prevailed because it had proposed a budgetary cap higher than what the other party had been requesting. It was important to support the staff in its discussions with the World Bank staff, which the Director of the Policy Development and Review Department was seeking, while keeping open the right of Vietnam to call on Fund support.

Mr. Newman made the following statement:

> Like Mr. Autheman, I can support some version of Mr. Donecker's first two points, though the third point seems to exaggerate the issues at stake and create a precedent by setting an overall cap to access to a specific facility rather than using normal access policies to ensure that a facility operates in a financially prudent manner. I assume that any use of ESAF resources for DDSR operations will be bound by the access rules of the ESAF, meaning that the Fund will not provide resources in excess of normal access limits. Therefore, I can support the staff's proposal.

Mr. Donecker commented that the Fund had already had de facto ceilings on the availability of resources under various facilities, such as in regard to the previous Supplementary Financing Facility or Witteveen Facility, and initially with the SAF. Under the latter, the Fund, while agreeing that low-income countries would be eligible for the facility, had indicated that only a certain amount of financing overall was available. The SAF, indeed, had been intended to be a temporary facility only. The advantage of having an irrevocable upper limit to ESAF financing for DDSR operations would be its clarity: the World Bank, IDA, and Fund staff would all be well aware of the cap. Moreover, a cap would also help to ensure equal treatment of member countries, in that the Fund would have to consider all ESAF-eligible countries as potential candidates for ESAF support for DDSR operations. A cap would enable the staff to state to IDA that more ESAF financing for a particular country's DDSR operations was not available, given that the resources had already been, or would be, used to support other ESAF-eligible countries.

Mr. O'Brien made the following statement:

My chair continues to support the staff's proposal. We share, nonetheless, the concerns expressed by Mr. Bernes and other Directors that, in supporting DDSR operations with ESAF resources, the Fund should not undermine the continuity of the ESAF. While I also agree with Mr. Donecker's first two points, the staff's proposal is based already on the fact that ESAF resources will be residual only, and not a substitute for IDA resources and other more concessional resources. While Mr. Bernes and Mr. Donecker have clearly articulated the risk that ESAF resources might substitute for other, more concessional resources—to the detriment of the countries concerned—one should ask what implications will be if the Fund does not support DDSR operations with ESAF resources. What message will the Fund send the contributors of other concessional resources? The staff, indeed, has made its proposal in light of a set of circumstances indicating that more concessional financing is required from the Fund.

As for the possible costs of the staff's proposal, the staff papers have made it clear that ESAF resources will not be used for DDSR operations for new debt. Hypothetically, while ESAF resources for DDSR operations would be available to all ESAF-eligible members, one could ask whether those members who have already carried out DDSR operations will also have access to the ESAF resources. It would thus make sense to add some safeguard to the proposal to prevent refinancing of DDSR operations, and to consider essentially only the countries mentioned already by the staff. As these countries' debt is well known, so is the potential aggregate use of ESAF resources for their DDSR operations. To this extent, there is no need for the Board to set an explicit cap on the use of ESAF resources for DDSR operations. As the staff has indicated that future costs under the proposal will be relatively modest, I continue to support its proposal.

Mr. Kaufmann made the following statement:

The staff in its comments on the Bernes-Chelsky proposal underscores the legal difficulties the adoption of this proposal would entail. As argued in our previous discussion, we think that the grant element of the ESAF resources used in a DDSR operation should be taken into account when defining the Fund's contribution to the HIPC Initiative. By contrast to World Bank facilities, the use of ESAF resources for commercial DDSR operations is something new and, therefore, truly additional to existing mechanisms.

If the grant element of a DDSR ESAF credit is to be considered as a portion of the Fund's contribution at the completion point, only operations for HIPC-eligible countries in the second stage of the Initiative can be financed. We agree, therefore, to limit the use of ESAF resources for DDSR operations to countries qualifying for relief under the HIPC Initiative, as suggested by the Bernes-Chelsky proposal. In case this proposal was not adopted, we would nevertheless encourage the staff to further investigate the legal possibilities for considering the ESAF resources used in commercial DDSR operations as part of the Fund's contribution to the HIPC Initiative.

The staff points out that the Bernes-Chelsky proposal would need the creation of a new sub-facility. However, it is our understanding that, should the Bernes-Chelsky proposal be adopted, Fund support to DDSR operations could be financed through the HIPC-Trust Fund, which already represents a special form of ESAF operations. While this would still require a modification of the Instrument, no subfacility for HIPCs would be needed.

Finally, in our view financial involvement of the Fund in commercial DDSR operations has to be of a limited and subsidiary scope. The World Bank should continue to assume the leading role in this kind of operation. ESAF financing should be used as a last resort, when the country's own resources, IDA financing and grants from bilateral donors have proved insufficient. Fund support to a DDSR operation should not be compulsory. We are, therefore, opposed to any more or less fixed range of burden sharing. In this respect, we would encourage staff to elaborate some guidelines defining the Fund's contribution to commercial DDSR operations.

In the case of Vietnam, we support the staff's view that it is inappropriate to substitute ESAF resources for the more concessional resources the Bank staff had earlier indicated to be available for this operation.

Mr. Zoccali made the following statement:

Despite the legitimate concerns voiced by Mr. Bernes, we maintain our support for the staff's proposal on grounds that it would not alter significantly the subsidy cost of the targeted financing requirement for the ESAF-HIPC Initiative, and would avoid introducing a double standard of conditionality under Fund arrangements and the creation of yet another Fund facility.

Our support for the proposed decision to amend further the ESAF Trust Instrument does not preclude further clarification with the World Bank regarding the burden-sharing expectation that ESAF financing be used in a subsidiary or last resort role. In that regard, I would associate myself with the comments of Messrs. Autheman and Newman with respect to the third point of Mr. Donecker's position. Inclusion in the text of the decision or the summing up of a specific reference to the review of use of ESAF resources for such purposes could perhaps serve to reassure that the policy would be carried within the financial parameters envisaged, (in Table 1 of EBS/97/94, Sup.1), to avoid giving an impression of relaxation of the established efficiency standards for supporting DDSR operations.

Finally, it remains our expectation that the upcoming costing paper will shed light on the opportunity costs for the Fund resulting from further delay both in transfers of SCA-2 resources to the ESAF Trust and gold sales and investment of profits therefrom. Rapidly ensuring the availability of sufficient resources to meet the targeted financing requirement for ESAF/HIPC seems to us essential if we are to preserve the integrity of the initiative and the credibility of our efforts in this regard.

Mr. Han stated that his chair continued to support the staff's proposal, with the provisos that uniformity of treatment of all ESAF-eligible countries would be maintained and that total use of ESAF resources for commercial DDSR operations would be limited.

Mr. Rouai indicated that he supported the staff's proposal, and that he agreed with Directors' concerns about Mr. Donecker's third point, to set an irrevocable cap on use of ESAF resources for commercial DDSR operations. He wished to point out that the lower estimate of the Fund's possible contribution to such operations, of $125 million, did not include the interest subsidy, estimated by the staff to be about SDR 30 million.

Mr. Shaalan said that, after listening carefully to other Directors, he wished to reiterate his support for the staff's proposal. He believed that Mr. Donecker's first two points were already well covered in the staff's proposal, namely, the need to ensure that ESAF resources were subsidiary to other resources, and adequate burden sharing.

Mr. Vernikov remarked that he continued to support the staff's proposal. As for the difficult issue of burden sharing, it was unclear what the staff meant in stating that it had been informed that it could not advise the Board that the World Bank would proceed with the DDSR operations without Fund support; that point seemed to mean that the Bank would not proceed with such operations without Fund support. He was looking forward to hearing the views of the Board in the Bank on burden sharing, but believed that Vietnam should not be excluded from ESAF support for its DDSR operation.

Mr. Disanayaka stated that he broadly supported the staff's proposal, though he had some concerns, particularly as funding for the interim ESAF was not yet fully secured. As Mr. Zoccali had noted, the Fund needed to have a better idea of the adequacy of funding for the interim ESAF before committing substantial ESAF resources for commercial DDSR operations. He agreed that the Fund should not support Vietnam's DDSR operation, and that the World Bank should abide by its earlier agreement with the staff to support that operation without concomitant Fund support.

Mr. Shields said that he wished to thank Mr. Bernes and Mr. Chelsky for their efforts to find a better means of supporting DDSR operations in low-income countries. As those efforts had not succeeded, he was prepared to support the staff's proposal. As for Vietnam, the Bank staff should not renege on its earlier commitment to finance that country's DDSR operation, and the Fund should not substitute its less concessional ESAF resources for the more concessional IDA resources. Moreover, he continued to believe that use of ESAF resources for DDSR operations should be counted as interim assistance from the Fund under the HIPC Initiative. He also agreed with the reservations of other Directors about Mr. Donecker's third condition—to set an irrevocable cap on ESAF resources for DDSR operations—which would be neither appropriate nor manageable.

Mr. Toribio remarked that, although Mr. Bernes and Mr. Donecker had made some valid points, he saw no reason to reverse his support for the staff's proposal.

Mrs. Guti reiterated that she continued to support the staff's proposal.

Ms. van Geest said that she also continued to support the staff's proposal. While Mr. Donecker and Mr. Bernes had a valid concern regarding the possible substitution of ESAF resources for IDA resources, a cap on the use of ESAF resources for DDSR operations would not be useful. First, it was probably not legally possible for the Fund to bind itself irrevocably in the future: in other words, a cap could be set, but that was no guarantee that it would not be changed in the future. Second, as Mr. Autheman had pointed out, a cap would serve as a floor for IDA. The most effective means of ensuring that IDA resources were used to support commercial DDSR operations would be for all authorities to communicate such to their Executive Directors at the World Bank. If that were the case, ESAF resources might never be used to support DDSR operations. While that would be the optimum solution, it was not certain. Her chair therefore supported the use of ESAF resources for DDSR operations, given that countries might otherwise opt to use GRA resources for such operations, which was precisely what her chair would oppose.

Mrs. Gonzalez said that she shared the concerns of Mr. Bernes, Mr. Chelsky, Mr. Donecker, and Mr. Disanayaka. Nevertheless, as a majority of Directors supported the staff's proposal, she could support the staff's proposal, subject to Mr. Donecker's first two conditions. She also supported option 3 regarding access and phasing of ESAF support.

The staff that resist pressure from the World Bank that would result in the substitution of ESAF resources for more concessional IDA resources, Mrs. Gonzalez added. The staff should provide some safeguards or a set of principles to ensure that no such substitution took place, as it would be to the detriment of the countries concerned.

Ms. Srejber made the following statement:

> I share the concerns raised by many other speakers. I am still skeptical to the proposals at a time when sufficient funding of ESAF and HIPC has not been secured, when the cost estimates are not very precise, and when burden sharing is unclear. I agree with those speakers who have said that it is a bit surprising that so-called Bank policy has not been discussed in the World Bank Board. For my part, I have communicated that to relevant counterparts.
>
> However, it seems as if there is anyhow a large majority for embarking on this avenue of using ESAF resources for DDSR operations. As this seems to be the case, I would like to state that this chair does not want to limit the possibility of use of ESAF resources for DDSR to HIPC countries only. I share the view expressed by many speakers that use of ESAF resources for DDSR should be a last resort. Down to specifics in the staff's proposal, I would

support Option 3 and I do not think that the Fund should claim credit for this use of ESAF resources under the HIPC initiative.

Finally, on Vietnam, I support the staff's view. I think it is of very large concern that the World Bank staff has changed its position. I think, of course, that the prudent way of handling this should have been to have discussions in both Boards.

Mr. Kiekens reiterated his support for the staff's proposal. Nonetheless, he remained concerned about burden sharing between the international financial institutions and private creditors: the more the international financial institutions subsidized commercial DDSR operations, the more they would shift the burden of such operations to the public sector. As for burden sharing between the Fund and the World Bank, Ms. van Geest had suggested the appropriate solution, namely, for authorities to rely on their Executive Directors at the World Bank to ensure that the IDA-financed DDSR operations. If sufficient financing were not available, the country concerned would have to negotiate with its commercial creditors. The Board would have to ensure that financing of DDSR operations with ESAF resources remained within the limits envisaged by the staff.

The Director of the Policy Development and Review Department said that it was somewhat disconcerting to be fulfilling two functions—that of proposing to use ESAF resources for DDSR operations, and that of trying to secure contributions to the ESAF Trust—when some major ESAF contributors had reservations about the staff's proposal. The question of burden sharing in DDSR operations had arisen in 1989, when the Board had first discussed those operations for middle-income countries under the Brady Initiative. The Chairman's summing up of the 1989 discussion had stated:

> In these cases, Directors stressed that it was important that the two institutions worked together closely in securing effective debt reduction. This does not mean each institution must provide equal amounts in each case. As the amounts will need to be taken on a case-by-case basis, the managements of the two institutions are working closely on these matters and Executive Directors will be kept informed of the progress made in support of these operations on a continuing basis.

Since then, the staff had informed the Board in each case of the amount of debt relief to be provided by the Fund, the World Bank, the country, and bilateral creditors, which the Board had subsequently approved.

Until the present, the issue of burden sharing had not arisen for the DDSR operations of low-income countries, for which the World Bank had created the IDA Debt Reduction Facility and had agreed to provide grant support, the Director noted. The Bank had not previously asked the Fund help finance those DDSR operations, because the former had been willing to support the operations, together with bilateral contributors, provided that an agreement could be reached for DDSR operations based on a sufficiently large discount and a promise that debt buybacks would substantially reduce commercial claims against the country concerned. While that had been the case for most countries, a few remaining countries had yet to reach agreements on DDSR operations. In those cases, the staff had considered what role the Fund could play in the event that the IDA were to finance the DDSR operations with IDA credits—as opposed to grants—given the large upfront costs of the operations. The staff could have proposed using GRA resources in those cases—as for middle-income countries—but had instead proposed using concessional ESAF resources, as the countries were low-income ones. Regarding the specific case of Vietnam, discussions had been under way for some time between that country and its commercial bank creditors; and the World Bank had provided several indications to the Fund of the amount of financial support that it could provide Vietnam without accompanying Fund support.

The Board had been relatively satisfied with burden sharing in DDSR operations for middle-income countries, but was facing that issue in regard to a few remaining low-income countries that had yet to reach agreements on DDSR operations, the Director continued. The staff would certainly take into account Directors' concern that the use of ESAF resources be subsidiary or a last resort to the use of World Bank, country, and bilateral resources. Directors' guidance would be at the forefront of the staff's mind as it discussed burden sharing with Bank staff and the few countries concerned. While the staff could agree with Mr. Donecker's point that the ESAF resources used in DDSR operations should never exceed IDA resources, he doubted that Mr. Donecker's further suggestions to cap formally the use of ESAF resources for such operations at $150 million would be useful—though it was within the range of cost estimates provided by the staff in Table 1 of EBS/97/94. Mr. Autheman, for example, had noted that such a cap might effectively become the floor for the IDA. In any event, Directors could review the cost estimates or financial parameters of ESAF support for DDSR operations in the future, if it appeared that the aggregate use of ESAF resources for such operations would exceed the lower end of the range of estimates provided by the staff; such a review mechanism should preempt the need for a formal cap on the use of ESAF resources. While the Fund could not restrict, a priori, the provision of ESAF resources for DDSR operations to only a few specific countries, the staff had presented in Table 1 a list of ESAF-eligible countries with substantial commercial debt that could be potential candidates for such resources. To the staff's knowledge, there were no other countries that might need such support.

Mr. Giustiniani wondered whether the large upfront costs of some DDSR operations owed to an especially large stock of debt or to insufficient secondary market discounts on the debt. Moreover, he wondered whether the latter would recur in the future, expanding the list of countries needing ESAF support beyond that mentioned by the staff.

The Director of the Policy Development and Review Department commented that the debt stocks of some ESAF-eligible countries were indeed large compared with those dealt with previously under the IDRF, and the discounts on those debts had been somewhat smaller than in the past as well. For example, the current DDSR negotiations under way with Côte d'Ivoire were based on a discount of 79 percent, versus the average discount for previous DDSR operations financed by the IDRF of just over 90 percent. Under the Brady Initiative, the Board had expressed concern that the potential use of official resources for DDSR operations could affect the secondary market prices of the debt concerned. To meet that concern, that staff had, in each case under the Brady Initiative, presented a history of the secondary market price of the relevant country's debt; in most of those cases, the secondary market prices of the relevant debt had risen as negotiations with commercial banks on DDSR operations had proceeded, and as the country's adjustment program had improved economic prospects. It had not been possible to distinguish the relative contribution of either of those factors in increasing the secondary market prices of debt. Nonetheless, the staff would continue to provide a history of the secondary market prices of countries' debt, to assure

Executive Directors that it was not the prospect of official financing that was increasing the rate of return that commercial banks would accrue from DDSR operations.

The Acting Chairman made the following concluding remarks:

> The Board has now had a third round of discussions on the use of ESAF resources for commercial debt- and debt-service reduction operations, and a range of views has been expressed. Most Directors agreed with the staff's proposals on the use of ESAF resources for such operations. They noted that the proposed use of ESAF resources would represent an extension of the existing policy for supporting debt- and debt-service reduction operations (DDSR), and that such use would be guided by the same general principles concerning, inter alia, conditionality, efficient use of Fund resources, and market-based operations. In addition, Directors noted that the use of ESAF resources would complement the highly concessional resources available from IDA and other sources, and that those resources would be provided only in the context of appropriately ambitious ESAF-supported programs. In order to ensure that the use of ESAF resources for DDSR operations would be strictly limited, Directors considered that it would be desirable to limit such assistance to countries that currently had unresolved arrears to commercial banks.
>
> Several Directors expressed concern about the possible resource implications, as the financing of the interim ESAF and the Fund's participation in the HIPC Initiative had not yet been secured. Reflecting that concern, a few Directors expressed support for limiting the use of ESAF resources for commercial DDSR operations to countries that qualified for assistance under the HIPC Initiative, and providing such support only under ESAF arrangements in the period between the decision point and the completion point. Many Directors, however, expressed the view that targeting only qualifying HIPCs would unduly constrain the number of countries that could receive such assistance. Those Directors also considered that the proposed use of ESAF resources would not unduly affect the resource constraint. While a few Directors would have preferred a cap on the use of ESAF resources for DDSR operations, Directors generally accepted that the policy being proposed would be carried out in a way that would result in costs to ESAF that would remain well within the financial parameters presented in EBS/97/94. The use of ESAF resources for DDSR operations would, of course, be decided by the Board in each individual case, and the overall use of ESAF resources for those operations would be subject to review by the Board if it appeared that the aggregate resource use for that purpose would exceed the lower end of the range of estimates provided in the staff paper.
>
> With regard to the options presented by the staff for dealing with the possibility that a debt- and debt-service reduction operation might not materialize following a disbursement of ESAF resources for that operation, most Directors favored the third option presented in the staff paper, that was, to incorporate into the ESAF Trust Instrument a provision for a special disbursement for the sole purpose of financing part of such an operation. That

provision was expected to be used only when the disbursement for that operation could not simply be part of a normal semi-annual disbursement.

Although different views were expressed on the topic, most Directors agreed that the Fund should not seek to claim credit for the use of ESAF resources for DDSR operations in calculating the Fund's contribution to the HIPC Initiative.

Finally, on burden sharing, Directors agreed that there should not be strict rules, but that it should be subject to discussion in each case, considering also the prospects for bilateral contributions and the use of the country's own resources. Directors expressed the view that ESAF financing for DDSR operations should be used in a subsidiary or "last resort" role, only if other options for financing were not available. In the particular case of Vietnam, although it would be eligible under the policy to use ESAF resources for its DDSR operation, most Directors felt that such use would not be appropriate in view of the likely substitution of ESAF resources for the more concessional IDA resources, which were expected to be made available for that operation.

The Executive Board took the following decision:

1. The Instrument to Establish the Enhanced Structural Adjustment Facility Trust annexed to Decision No. 8759-(87/176) ESAF, as amended, shall be further amended by adding the following subparagraph at the end of Section II, paragraph 3(b):

"Notwithstanding the previous subparagraph, if in the determination of access under a three-year arrangement or at the time of approval of an annual arrangement, resources are committed to help finance the cost of a debt- and debt-service-reduction operation with commercial banks, the resources so committed shall be disbursed only at the time the operation materializes, the program supported by the arrangement remains on track, and the Executive Board is satisfied that such use would be efficient and market based; provided, however, that the resources may be made available from the outset of an arrangement if the above conditions are met." (EBS/97/94, Sup. 1, 6/30/97)

Decision No. 11533-(97/67) ESAF, adopted
July 2, 1997

4. INDIA—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with India (SM/97/147, 6/11/97). They also had before them a background paper on recent economic developments in India (SM/97/150, 6/17/97) and a paper on selected issues (SM/97/154, 6/18/97).

The staff representative from the Asia and Pacific Department made the following statement:

The following provides an update on economic developments since the staff report was issued. There are few signs yet of the hoped-for turnaround in industrial output, although the slowdown may have bottomed out. Following a sharp drop in the 12-month growth of industrial production between October 1996 and January 1997, the growth rate averaged about 2 percent (annualized) in January–March 1997. Forward-looking indicators of activity such as bank credit to the commercial sector and non-oil imports have stabilized in recent months, but growth rates remain subdued. Nevertheless, tightening inventories in some sectors, a recovery of stock market prices, and business surveys showing a rebound in business confidence—after passage of the 1997/98 budget and the resolution of uncertainties over the composition of the government—offer some indications of an eventual turnaround in industrial production later this year. On this basis, the staff forecast for GDP growth in 1997/98 as a whole would be in the 6–6½ percent range.

Wholesale price inflation has remained on a moderating trend, declining to 5.9 percent in mid-June, as food prices have stabilized. A decision to raise petroleum product prices has still not been taken, implying a continued large deficit on the oil pool account. The staff estimates that an average petroleum product price increase of around 15 percent would be needed to eliminate the oil pool account deficit.

Based on more complete, but still provisional, data, the deficit of the central government is now estimated at 5.2 percent of GDP in 1996/97—0.2 percent of GDP higher than the earlier estimate reported in the staff report. Tax collections—primarily indirect taxes—turned out 0.3 percent of GDP weaker than initially estimated while expenditures were 0.1 percent of GDP lower than estimated. Partial data on tax revenues in April–May 1997 suggest a continuing weakness in tax collections in the 1997/98 fiscal year, consistent with sluggish industrial growth. While it is still too early to reach a firm judgment on the impact of the budget tax cuts, it looks increasingly likely that additional measures will be needed to achieve the deficit target. The staff's advice would be to implement measures at an early stage consistent with the necessary medium-term fiscal restructuring and to avoid ad hoc expenditure cuts that would risk falling on productive categories of expenditure. Priorities would include adopting the Pay Commission recommendations to lower civil service employment and contain wage costs; increases in food and fertilizer prices to reduce subsidies; pruning redundant plan and centrally sponsored schemes; containing defense spending; and moving speedily on public enterprise reform and privatization.

Broad money growth has increased to 16.6 percent (12-month basis) in early June 1997—above the Reserve Bank of India's (RBI) announced target range of 15–15½ percent for 1997/98—mainly owing to a continued buildup in external assets. Despite the measures taken in the RBI's April 1997 monetary policy statement, growth in bank credit to the commercial sector remained sluggish in April–May 1997. On June 25, the Reserve Bank announced a further cut in the bank rate from 11 to 10 percent. Subsequently, several commercial banks have reduced their prime lending rate from 14 to 13½ percent.

In the wake of the emergence of major losses in CRB Capital Markets (one of the largest nonbank finance companies (NBFCs) with reported assets of Rs 60 billion) as a result of allegedly fraudulent practices, the RBI has taken several steps to tighten its supervision of NBFCs over the past month.

All NBFCs have been required to apply for registration with the RBI by July 8 and to provide more detailed information in such areas as compliance with prudential norms, investment and income performance, and medium-term management plans.

The minimum statutory liquidity requirement was raised from 5 percent to 10 percent for currently unregistered companies and from 10 to 15 percent for currently registered companies, to be phased in by April 1998.

More intensive monitoring has been announced for the 10 largest NBFCs.

Steps were announced to improve the data base and increase the personnel assigned to supervise operations in the NBFCs.

While the RBI was already moving in the direction of strengthening its oversight over the NBFCs, it was only legally empowered to supervise the asset side of the NBFCs' balance sheets by an amendment to the Reserve Bank of India Act in March 1997. Following these recent measures, the RBI is considering further steps to tighten the regulatory and supervisory framework applying to the NBFCs, including more stringent entry norms and improved disclosure requirements.

India's foreign exchange reserves have continued to rise in recent months, reaching $24.6 billion (over six months of imports) in mid-June, based on continued buoyant private capital inflows. Trade growth meanwhile remains weak; exports in April–May 1997 were slightly below their level in the corresponding period of the previous year. The rupee has continued to be stable against the U.S. dollar. In real effective terms, the exchange rate has depreciated by an estimated 2½ percent since March 1997 in view of the dollar's decline against other major currencies.

The WTO Committee on Balance of Payments Restrictions was not able to reach understandings with the Indian authorities on a timetable for phasing out quantitative import restrictions in its meetings over June 30–July 1. The Indian proposal was to phase out these restrictions over a seven-year period, but the Committee could not reach agreement on this basis. As a result, quantitative restrictions no longer have cover under Article XVIII:B at the WTO, implying that India would now be liable to legal complaints under the WTO's dispute settlements procedures.

Mr. Sivaraman made the following statement:

At the outset, I would like to place on record our deep appreciation to the staff who, under the able stewardship of Mr. Neiss and Mr. Goldsbrough, have produced a report which is critical yet balanced and has given invaluable suggestions for future course of action.

The Indian economic performance during 1996/97 has turned out to be impressive on several counts. Interest rates have declined, prices have remained largely under control, agricultural production increased by 4 percent, foreign exchange reserves increased considerably, current account deficit is lower and capital inflows have increased. The recent decline in interest rates will spur investment. Moreover, the investment proposals in the infrastructure sectors will be facilitated by the establishment of a transparent and sustainable policy framework on which a number of steps have been taken. With the output growth in 1996/97 at 6.8 percent, the Eighth Plan is likely to end with an overall annual growth of 6.5 percent, 0.9 percentage points higher than the targeted rate of 5.6 percent, and 0.5 percentage points higher than the actual achievement of the Seventh Plan. The pace of reforms has been accelerated by a series of policy announcements by the government.

The Indian economy since 1980/81 has been growing at an average rate of about 5.8 percent in the last 15 years and at an average rate of about 6.5 percent in the last four years since the reform started taking roots. Considered in the light of the rate of growth of output in many other countries, this was commendable performance. When compared with the performance of the neighboring East Asian economies, which have shown an average growth of over 8 percent, India's performance has room for improvement.

The external liberalization of the economy, a matter of some international interest in recent times, has continued in a smooth and quiet way. Quantitative restrictions have been removed on more than 75 percent of the tariff lines since the onset of reforms in 1991. Furthermore, in the current year alone, quantitative restrictions have been removed on one-sixth of those remaining in the list and the Budget for 1997/98 has brought down the peak rate of customs tariff from 50 percent to 40 percent. Our authorities have also announced India's intention to align her tariff rates with that of ASEAN by the turn of the century. What needs to be recognized is that India has been quietly and steadily liberalizing her external trade regime without evoking a popular backlash against the reform process and containing the cost of adjustment to manageable limits. The track record of the past six years provides enough assurance about the continuity of the process.

Despite the impressive performance of the economy in 1996/97 on several fronts, the economy did slow down a little compared to the previous year. Industry has attributed the slow down to uncertainties on the political front and high rates of interest arising from a tight monetary policy. Infrastructure bottlenecks have also emerged. With the new credit policy and reduced rates of interest, we are optimistic that growth will rebound to earlier peak level. A strong growth in bank deposits combined with substantial reduction in cash reserve requirements has resulted in abundant liquidity in the system in 1996/97. However, the offtake of bank credit was subdued. Short-term money market rates have moved down consequent to the easy liquidity conditions. Inflows of foreign reserves through the balance of payments have also contributed to amelioration of tight monetary conditions. Lending rates which are known for their stickiness and which remained at a high level during the first half of 1996/97 have softened thereafter. The application of new prudential norms on the financial system has led to a tightening of the credit appraisal process, and reevaluation of the credit risk of bank customers.

Our authorities are giving utmost attention for infrastructure development. As far as privatization of infrastructure facilities are concerned, investment has started taking place in ports, electricity supply and roads. Private sector power projects have started coming up in some States and governments have even opened water supply schemes to the private sector. Similarly, many States like Karnataka, Maharashtra, Andhra Pradesh, Rajasthan and Gujarat are moving forward aggressively to reorganize their finances and attract private investment in public utility services.

The average rate of gross domestic savings has risen substantially from 20.9 percent of GDP in the year 1987/88 to 25.6 percent of GDP in 1995/96 due to a rise in private savings. We are aware that the enormous investment needs of the economy will result in a gradual widening of the current account deficit over time. However, a rise in the domestic rate of saving will help contain the savings—investment gap well within manageable limits.

As far as the fiscal front is concerned, government has been progressively reducing the fiscal deficit. The 1997/98 budget was acclaimed by the financial community as a landmark budget. This budget continued the process of fiscal consolidation. However, the reduction in fiscal deficit has been constrained by two major factors, namely interest payments and inability to reduce subsidies on fertilizers and food. The government of India has recently issued a white paper on subsidies and initiated a public debate on the need to reduce subsidies. There have been reductions in subsidies in many areas and a high level committee of experts are looking into the methodology by which fertilizer subsidy can be reduced or eliminated.

The reduction in fiscal deficit has to come through revenue increases and reduction in expenditures of the government. This is being vigorously pursued. In a bold and determined effort, the 1997/98 budget lowered rates of direct taxes across the board on personal income bringing the tax rate down from 40 to 30 percent. Dividends from domestic companies were fully exempted from personal income tax. The effective rate of corporate tax on Indian companies was slashed from 43 percent to 35 percent—a move that is expected to give a fillip to the supply side of the economy. The rate of customs duty on capital goods was also brought down from 25 percent to 20 percent. As far as expansion of revenues is concerned, the apprehension of the staff that the 'bold cuts may not result in buoyant revenues' is understandable. The government are examining the report of an expert group on direct taxes reform which contains a number of suggestions for removal of exemptions under direct taxes.

I agree with the staff that there is a delicate macro-balance now and if there is a shortfall in tax revenues or a major failure of monsoons, then this balance could be upset leading to pressures eventually on the inflation front. My authorities are very watchful and would not hesitate to take appropriate action to keep inflation under check.

There has been undoubtedly some delay in the revision of petroleum prices to wipe out the deficit on this account and it is expected that shortly the government will revise the prices and probably move toward a replacement of the administered price mechanism to a market determined system in the hydrocarbon sector.

The ongoing financial sector reform program aims at promoting a diversified, efficient and competitive financial sector with the ultimate objective of improving the allocative efficiency of available resources, increasing the return on investments and promoting an accelerated growth of the real sector of the economy. With a view to facilitating the development of an orderly term market and a realistic rupee yield curve, interbank liabilities have been exempted from the maintenance of cash reserve ratio since April 15, 1997. We are already on the downward path in regard to the effective CRR which is now less than 10 percent and the SLR has also been brought down from the pre-reform peak of an effective rate of 37.5 percent to an overall effective level of 26.7 percent in March, 1997. With the incremental SLR set at 25 percent, over time the average SLR will come down to 25 percent. The Bank rate was again reduced by the Reserve Bank of India by 1 percentage point to 10 percent signaling the need for further reduction in interest rates to give a boost to the economy.

A bold and radical change which would strengthen fiscal discipline and provide greater autonomy to the RBI in conducting monetary policy in the coming years is the discontinuation with effect from April 1, 1997 of the system of ad hoc treasury bills and 91-day tap treasury bills to finance the budget deficit and the introduction of a scheme of ways and means advances (WMA) by the RBI to the central government to accommodate temporary mismatches in the government receipts and payments. WMA will not be a permanent source of financing the government deficit. The RBI is committed to following a strict stance of the monetary policy. Given the real GDP growth of 6–7 percent in 1997/98, monetary policy would seek to maintain the expansion in M3 in the range of 15–15.5 percent with a view to keeping the inflation at around 6 percent in 1997/98. The projected increase in money supply would be reviewed from time to time and revised depending upon macroeconomic developments.

Financial sector reforms have been implemented in a phased manner which, though cautious, achieved proper sequencing. Introduction of prudential norms, widening of the capital base and strengthening of the organizational infrastructure have all gone hand in hand. The first stage of the banking sector reform is coming to an end and we are now moving on to the next stage of the reform. There is no doubt that in the years to come, the Indian financial system will grow not only in size, but also in complexity as the forces of competition gain further momentum and as financial market acquire greater width and depth. Hence the thrust of the second phase of reform would have to be in the improvement of organizational effectiveness of banks and other financial entities.

In the year 1996/97, the operational profits of the public sector banks as a whole are expected to improve noticeably. Almost all public sector banks abide by the international capital adequacy and prudential norms. RBI have been liberal in permitting the setting up of private sector banks and expansion of foreign banks in India. It is a fact that banks are not allowed to exit in India. Government and the RBI make their utmost efforts to rectify a weak bank and bring it back on rails without allowing it to collapse. I can assure the Board that there is acute awareness both in the government and the RBI to make the Indian banking sector vibrant, dynamic and competitive. From the variety of performance indicators available, it can be said their functioning is getting better by the year.

There has been a slow down in the growth of exports in 1996/97. Among the significant reasons for this slow down are the deceleration in the world trade growth in 1996 and in particular, deceleration in the growth of major trading partners in the neighboring countries, inadequate availability of nontradable infrastructure services, and appreciation of the US dollar against third currencies. The impact of variations in cross currency rates is evident from the fact that during the year 1996/97, exports valued in SDR terms grew by 9.5 percent compared to only 4.0 percent when valued in dollar terms. Export growth in 1997/98 may pick up as the world trade in 1997 is expected to rise. Preliminary data reveals that the growth rate of exports rose to 8 percent in May, 1997. This is an important welcome development though it is obviously too early to be sure.

The other area of concern is the surging capital flows into the country which has led to the foreign currency assets reaching a record level of about $25 billion. This may go up further with acceleration of foreign direct investment that has been witnessed in the first quarter of 1997. The authorities have adopted a flexible approach toward managing the exchange rate and resorting to open market operations to reduce liquidity. The government of India announced in its budget of 1997/98 its intentions to move toward capital account convertibility and had asked the RBI to appoint an expert group to make recommendations in this regard. The committee has made far reaching suggestions in regard to the control of inflation and improving the viability of the banking sector. The staff has also suggested phased implementation of capital account convertibility in line with progress made in other related areas and so has the committee. These are under active consideration of the government.

Government, at both the center and state levels, are now diverting more and more resources toward the social sector in order to achieve universal primary education and total literacy. The government of India has proposed an amendment to the constitution to make universal primary education a fundamental right and a responsibility of the citizen. Resources of the central government are being augmented to supplement the resources of the States in achieving this objective. Similarly, concerted efforts are being made to reduce the net reproductive rate. Some States in India have already achieved a net reproductive rate of 1 or very close to 1.

The government of India have received three reports from the Disinvestment Commission which are now being examined for implementation. Similarly, the State governments have also started disinvesting in their public enterprises. The State of Gujarat has prepared a plan of action in this regard. The State governments have started reorganizing the State electricity undertakings to make them viable organizations. A proposed amendment to the Central Electricity Supply Act will enable the setting up of autonomous tariff regulatory bodies.

There are references in the staff report to certain continuing restrictions in the current account. These restrictions have been inherited from the past on account of bilateral agreements with certain countries and except in the case of Russia, with all the other countries the amounts are insignificant and will be used up shortly. The other restrictions referred to are under the consideration of government of India.

On the statistical front, the staff report suggests ways to improve Indian statistics, including the reduction of delays. Steps are being taken to remove the deficiencies. Ground work for quarterly estimation of GDP is being done and we thank the Fund staff mission for their advice in this area. While quick estimates of all data concerning balance of payments are available within weeks of the close of the accounting year, there have been difficulties in finalizing them for want of certain details from the foreign exchange dealers. It is expected that these difficulties will be overcome shortly.

In the medium term, the objectives of our authorities is to maintain output growth at least at 7 percent, progressively reduce fiscal deficit to 3 percent, disinvest in the public sector in a phased manner while improving their functioning and profitability, keep inflation under check through appropriate monetary policies, tighten tax administration, modernize Income Tax law, adopt a flexible exchange rate policy and create a macroeconomic environment for sustained growth of the economy.

Mrs. Gotz-Kozierkiewicz made the following statement:

India's economy has experienced rapid growth over the past years, while reducing inflation and maintaining a strong external position. Although the economy will achieve in 1996/97 a robust 6.5 percent growth rate, a recent deceleration of industrial growth has raised concerns of a possible economic slowdown. Among other measures, the authorities have responded by reducing taxes and adopting a more expansive stance for their monetary policy.

The risk that such a strategy feeds inflation pressures is in our view limited, since the economy does not seem to show any sign of accelerating inflation. The increase observed in price indices largely reflects adjustments of administered prices rather than capacity constraints. The reason for this is that structural constraints do not seem to have been the main force behind the slowdown in industrial production. The average rate of capacity utilization has remained unchanged since last year.

A more probable explanation for the slowdown in industrial production should be sought in the increased difficulties in financing private investment. The stock market has been weak, real interest rates high and commercial banks increasingly reluctant to lend to the private sector. Most of the slowdown in industrial production is accounted for by industries producing capital goods and durable consumer goods, suggesting that investment may be less strong than currently estimated.

In the short run, the risk may be limited that the more expansive policies translate into excessive demand pressures and accelerating inflation. However, in the medium term, if investment does not pick up and needed structural reforms are not implemented, capacity constraints will rapidly show up and India will face increasing difficulties to generate high growth rates.

Concerned about the impact of high real interest rates on investment and growth, the central bank has progressively adopted a less restrictive stance. The cash reserve ratio has been cut several times, improving the liquidity situation of commercial banks. The staff points out, therefore, that there may be a risk that this liquidity could fuel too rapid credit growth.

The outcome, however, could also be just the opposite: insufficient credit growth. Despite the improved liquidity of banks, commercial credit has not significantly picked up. Banks have been reluctant to grant loans to the private sector and preferred using their liquidity to purchase government securities, as the significant reduction in rates on government T-bills shows.

This risk-averse strategy stems partly from a more stringent application of supervision and prudential regulations. Recent court cases in which bank officers were held liable for approving loans that subsequently performed poorly do certainly not contribute to reviving commercial lending.

Weak lending and investment would be worrisome for India's fiscal situation. The 1997/98 budget bets on a strong growth rate to achieve the targeted deficit reduction. To reactivate private investment, direct tax rates and import tariffs have been cut. Expenditure is, however, expected to remain broadly stable in relation to GDP. To offset the impact of the sharp cuts in taxation, the budget relies upon a strong supply response allowing a rise in tax revenues and upon improved tax compliance.

The authorities also expect higher divestment receipts. However, last year's experience has illustrated how unreliable and dependent on stock market developments this source of financing can turn out to be. Moreover, the sustainability of a fiscal consolidation excessively based on divestment receipts considered as revenue could be put into question. The risk of slippages must thus not be underestimated. We, therefore, support the staff's suggestion that a package of contingency measures be ready, should revenues begin falling below target levels.

India is, however, not only facing difficulties with its investment rate. The composition of this investment is also problematic. As the staff points out, despite high rates of investment in the past, key sectors such as infrastructure are relatively less developed in India than in other Asian economies. Faced with an increasingly difficult fiscal situation, States, for instance, have responded by cutting their development expenditure, affecting mainly investment in basic infrastructure such as power, irrigation and transportation networks. We therefore welcome the government's recognition that expenditure needs to be reoriented toward priority areas and encourage it to rapidly carry through this intention.

As a recent World Bank report pointed out, this problem of the composition of investment stems also partly from the States' pricing and sectoral policies and the associated implied subsidies. We therefore urge the authorities to pursue their liberalization and privatization efforts. In this respect, we particularly welcome the discussion paper the government issued on budgetary subsidies and its intention to promote a public debate on the subject.

Finally, we welcome the authorities' strategy to achieve capital account convertibility. This objective, however, should not be reached too hastily. While implying considerable potential gains, successful capital account liberalization requires demanding preconditions. The process should therefore be carefully phased with fiscal consolidation and with banking reforms to ensure financial institutions are ready to cope with the new environment. Should more time be needed than expected for these measures to be implemented, the authorities' timetable should be flexibly adapted.

Mr. Mirakhor made the following statement:

As noted in the well-written staff report and Mr. Sivaraman's helpful statement, India's economic performance in recent years has surpassed all expectations. Growth has been robust, broad-based, and substantially faster than the average of previous decades; private savings and investment rates have risen sharply; inflation has been contained to moderate levels, and the strength of the external current account has been bolstered by rising private capital inflows and a comfortable cushion of reserves. The credit for this favorable performance is due to the effects of policies initiated by the authorities in early 1990s, their continued commitment to prudent macroeconomic policies as well as implementation of key structural reforms.

While real GDP growth in 1996/97 was quite favorable, there were indications that the economy's growth impulses were beginning to weaken. Industrial production, investment and export growth, previously a source of considerable dynamism, slowed sharply, raising concerns that the strains of a still high fiscal deficit and a tight monetary policy stance were becoming more intense. In response, timely steps were taken to ease monetary policy. The authorities' pro-growth budget for 1997/98 aimed at boosting investor confidence through bold tax and tariff reduction measures, and a broadly unchanged level of government expenditures. Important steps have also been taken to liberalize the trade system, ease restrictions on foreign investment, and implement reforms in the financial sector. These measures hold the promise of placing the Indian economy on a more durable growth path, driven by a fast pace of investment and exports, in an environment of low inflation and financial stability.

As the staff notes, the budget for 1997/98 is not without downside risks. It is important to carefully monitor fiscal developments in view of the projected rebound in divestiture receipts and rise in tax revenue due to better compliance, as well as the implications of salary increases that are recommended by the Fifth Pay Commission for states and public enterprises wage bills. The proposed adjustment in petroleum product prices, along with a dismantling of the administered price mechanism to make it more responsive to market forces, would need to be implemented in a timely fashion to ensure that the overall public sector deficit is placed on a firmly downward course. We are reassured by the authorities' clear perceptions of the balance of risks in budget implementation and of the need for close monitoring, and commend them for their readiness to take additional contingency measures to safeguard their fiscal objectives.

The staff also notes significant risks to the price-output mix in 1997/98 arising from a looser monetary policy stance. Striking the right balance between the desire to stimulate growth in line with the economy's underlying potential while avoiding an undue build-up of demand pressures will present a challenge for policymakers. While inflation remains contained, the evidence of a pickup in the price of nontradables amid growing supply constraints and a steepening of the yield curve could portend an intensification of inflationary pressures. It is important to monitor price developments closely and to take prompt action should inflation start to turn upwards.

The expectation is that the external position will remain favorable in 1997/98, with a rebound in both exports and imports and continued large capital inflows. The authorities' pursuit of a more flexible exchange rate policy in response to private capital inflows is appropriate. However, we share their view that the margin for upward flexibility is circumscribed by concerns over a loss of competitiveness. Under the circumstances, the staff is correct to stress that, in addition to some upward flexibility in the exchange rate, the most effective means of coping with surging capital inflows would be through a faster pace of trade liberalization and, possibly, some easing of restriction on capital outflows. We welcome the authorities' intention to move toward capital account convertibility over the next three years. The report of the Committee on Capital Account rightly stresses the need for capital account liberalization to move in tandem with domestic adjustment, including greater autonomy for the central bank and a major strengthening of the financial system.

The adoption by the government of the goal of lowering the central government's deficit to 3 percent by the turn of the century is significant, but will need to be reinforced by determined adjustment efforts elsewhere in the public sector, including the public enterprises and state governments. Deeper structural reforms are also needed in those areas where progress has been less visible, such as in reducing the burden of subsidies. In this context, the staff may wish to comment on the recent white paper prepared by the Ministry of Finance that estimates that central and state government (implicit and explicit) subsidies account for 15 percent of GDP indicating "an unduly large and ill-directed subsidy regime," in which much of the subsidies are "probably appropriated by the middle to high income groups."

India's medium-term economic prospects seem highly favorable, with the economy expected to grow in line with its much improved growth potential, and with macroeconomic balances that are broadly sustainable. The key challenge is how to raise India's growth rate to the 7–8 percent range, in order to make substantial and durable progress toward poverty reduction. The lesson for India that is drawn from the experience of successful Asian countries—presented in the background papers on how to foster a virtuous circle of savings and growth—is illuminating.

The authorities recognize the benefits of faster adjustment as described, for example, in the staff's "strong adjustment scenario," but feel that the political costs of adopting such a course are high. Sustainability of reforms requires that their pace be tailored to political realities; however, too slow a pace of adjustment and reform in critical areas risks exerting a serious drag on overall macroeconomic performance, and could undermine the attainment of objectives of high growth and poverty reduction. Indeed, there is accumulating evidence that structural constraints in a number of areas are creating impediments to faster growth.

The most difficult task for a large plural democracy is to marshal the political forces necessary to initiate economic adjustment and reform. In India, this has already been accomplished with considerable skill and success. Following a brief pause with a minimal loss of output, the response of the Indian economy has been swift and overwhelmingly positive. This is in sharp contrast to the experience of other countries that have struggled for years before the benefits of adjustment and reform were felt. With the economy capable of much improved growth performance, one wonders if India's highly successful experience with bold adjustment and reform, and the ample cushion that is provided by the strength of external sector, does not provide a unique opportunity to move rapidly forward with a critical mass of new and growth-promoting reforms.

Mr. Sobel, on behalf of Ms. Lissakers, made the following statement:

I would like to thank the staff for a very comprehensive and illuminating set of papers. The papers document a reform program which is broad in scope and generally ambitious, although I think we would all agree that the pace of implementation has been slower than would be desirable.

Nonetheless, it is clear that India has set its economy on a new course of modernization that will position it to meet the challenges and reap the rewards of globalization.

The most dramatic evidence of this new direction is the surprising and very effective set of proposals for liberalization of the capital account put forward in the report of the Committee on Capital Account Convertibility. Capital account liberalization is critical to making the economy more competitive, bringing in greatly needed investment capital and deepening domestic financial markets. The proposed measures would move India out in front of a number of the region's more advanced economies in this regard. They would also send a clear signal to investors regarding India's commitment to deepen integration into the global economy and create a welcoming climate for investment.

As to the committee's specific proposals, the financial system preconditions laid out in the committee's report, such as complete interest rate deregulation and tightened prudential oversight of the banking system, would go far toward strengthening the domestic banking system and fostering financial intermediation. The report's proposal on establishment of transparent and impartial guidelines for foreign direct and portfolio investment would give foreign and nonresident investors the assurance that, at least among themselves, they were on a level playing field. Regarding capital outflows, however, the report proposes to retain caps on how much institutional, corporate and individual investors can invest abroad, and to limit bank's overseas borrowing and lending to 100 percent of Tier 1 capital by the year 1999/2000. The rationale is clear for retaining caps on banking outflows until banking sector reforms are implemented. However, I would like to hear staff's views on the feasibility of accelerated elimination of caps on individuals and corporations. Finally, we would note the importance of the report's proposal to fully open participation in forward foreign exchange markets for firms' ability to efficiently manage foreign exchange risk.

On a cautionary note, I would be inclined to side with Fund staff on the issue of the report's suggestions on dealing with weak banks. As many other members, including the U.S., have learned, postponing inevitable liquidations doesn't change the outcome but merely raises the cost both to the budget and to the economy as a whole. We concur with staff's views on the importance of explicit exit strategies for weak banks.

On page 29, paragraph 40, the staff notes that "the need to safeguard external viability would be an important consideration in determining the sequencing of liberalization." I agree with the need to give due consideration to issues of external viability, and with the approach of putting early emphasis on liberalization of FDI and portfolio equity flows. But preoccupation with the "right" sequencing can delay opening. The path to open markets is never perfectly smooth, but the rewards are worth a few bumps along the way.

Compared to the emphasis given to capital account issues in this set of papers, other areas of financial services liberalization seem to receive rather light treatment. The staff report notes that "continuing weaknesses in the financial sector have probably contributed to the recent slowdown of activity," and the selected issues piece on lessons from selected East Asian economies makes special note of the importance of developing domestic financial markets in fostering growth. Yet state ownership continues to be the dominant form in India's banking sector, and prospects for privatization are unclear. In addition, nonperforming loans of publicly owned banks are reported to be 14 percent of assets which suggests at a minimum impairment of the system's ability to intermediate savings and investment. In follow-up discussions staff explained that in spite of the high level of nonperforming assets technical insolvencies were limited. Nonetheless, I would like staff to discuss both prospects for privatization and measures to address the issue of nonperforming loans.

The papers make scant reference to capital market development issues (market infrastructure, investor protection, corporate governance, regulatory issues, shareholder rights, etc.) or to private participation in the pension and life insurance sectors, although I note that the November set of papers provided a treatment of the government debt market. I know that USAID has a program of assistance covering many of these areas, and I would like to see staff do more here. In addition, entry by foreign banks still languishes, and we would like to hear from staff what prospects are in this area. Such entry will be key to introducing competition and world best practices in banking, and will in the long run lead to a weeding out of weak players and a tightening of currently high financial spreads.

Although I have focused so far on capital account and financial services liberalization, it is important to recognize that there is still much unfinished business with regard to the trade account. Protectionism is still strong. Average tariffs of 20 percent are high compared to the 13 percent average tariff among East Asian countries noted by the staff, and I note that goods no longer subjected to quantitative restrictions are typically moved to a high tariff rate, pushing up the average rate. Quantitative restrictions and reservation of products are still in evidence. The authorities' commitment to reduce or eliminate these barriers and expose the economy to the full play of market forces is welcome, but should be made more concrete and accelerated. In particular, we would reinforce the message imparted by staff to the authorities that there is no balance of payments justification for continuing quantitative restrictions (there are certainly abundant economic arguments for discontinuing them), and we urge the authorities to eliminate them as rapidly as possible.

At a projected 8.2 percent of GDP in 1997/1998, the consolidated public sector deficit continues to be a drag on savings, investment and growth. It is also clear that the consolidated fiscal deficit puts a burden on monetary policy. The selected issues paper chapter on lessons from other East Asian countries argues (p. 16, para. 26) that reducing current spending and reorienting it away from unproductive expenditures such as interest payments and subsidies is vital to initiating a strong virtuous cycle of growth, saving and investment. With 6.4 percent of GDP spent on subsidies and 4.6 percent of GDP on interest in the past year, India has ample opportunity to test this hypothesis. In addition, I think there certainly should be a redistribution of public spending in favor of the social sector and away, particularly, from defense. As I have stated before, I believe there appears to be a very large imbalance here relative to what the country and civil society need.

As in the past, we strongly encourage measures designed to widen the tax base, and in this context to reduce tax rates as appropriate. I note that the 1997/1998 budget takes some fairly bold steps in this direction. I should say that I sympathize with staff regarding concerns (p. 17, para. 19) about the potential for immediate returns from improved tax administration. Amnesty for "black" money has been successful in some countries. However, I would note that India has had similar amnesties in the past, with the most recent occurring just two years ago. I would encourage the authorities to also implement structural and institutional reforms that would permanently direct investment into the legitimate "above ground" economy. On this point, I would like to hear staff's views on what measures could be taken to prevent the need for another such amnesty in the future (the promise of which could serve to make the current amnesty more credible).

Regarding monetary and exchange rate policy, there are two issues I would like staff to discuss. First, the staff report (p. 19, para. 22) notes a "risk that the very liquid situation of commercial banks could fuel too rapid credit growth unless short-term rates are allowed to rise." Given the current unwillingness to lend and focus on improving balance sheets, what are the circumstances under which staff envision a too rapid credit growth? Second, the staff report (p. 5 of executive summary) notes that, ". . . strong capital inflows are likely to imply continued upward pressure on the exchange rate," and that authorities would be prepared to accept some limited nominal appreciation of the rupee. We agree with staff; exchange rate flexibility can help a country undergoing rapid structural change manage the pressures on external accounts that often accompany economic transformation. I would also point out that there is a contradiction in worrying about capital inflows appreciating the currency, on one hand, and on the other, insisting on capping Indian outward investment. Opening flows in both directions will help to equilibrate the exchange rate.

On statistical reporting issues, as staff point out, improvements in timeliness, periodicity, coverage and quality of economic and financial statistics would help speed the identification of trends in the Indian economy and hence the proper conduct of policy. They would also simplify Fund surveillance. India's subscription to the SDDS and initiatives to establish quarterly national income accounts and to improve timeliness of balance of payments statistics are positive developments in this direction. I would note that such improvements will be of help to India on quota issues.

I very much appreciated the staff's inclusion in the selected issues paper of the section on the important issue of the states' fiscal problems, which if left untended could rebound on the central government's fiscal situation.

In short, we endorse the direction of reform that India is pursuing, but would urge the authorities to accelerate the pace and broaden the scope.

Mr. Bernes made the following statement:

I would like to express my appreciation to staff for a very well-written and informative set of papers. In particular, I found the paper on the lessons for India from the experience of selected east Asian countries most useful. Such comparative regional analysis, and lessons to be learned from strong performers, should in my view be a more frequent complement to Article IV consultation reports.

The Indian authorities deserve this Board's commendation for the manner in which they are grappling with the complex challenges that face this large economy. The staff has highlighted the macroeconomic policies and structural reforms that are required to achieve high sustainable growth, to make significant inroads into the high poverty rate, and thus to realize India's potential. I am in agreement with the staff's policy prescription: tightening fiscal policy, maintaining a prudent monetary stance, and broadening and deepening structural reforms.

The reform process launched in 1991 has had positive results, and much progress has been made in macroeconomic stabilization and structural reform, the latter revolving around reducing the government's role in the economy and introducing market mechanisms. However, as was noted by many Directors during last year's discussion, these economic reforms need to be extended in a bold and far-reaching manner so as to put India on a high sustainable growth path.

One of the key challenges in this regard is the further reduction of the fiscal deficit that has resulted in the crowding out of private sector investment. The background paper on lessons from certain East Asian economies notes that the extent of India's fiscal consolidation effort falls well short of what was achieved in those countries, with the level of public savings in India comparatively low. The large fiscal deficit has also placed an undue burden on monetary policy in maintaining macroeconomic stability. I therefore urge the authorities to adopt a more ambitious approach to budgetary consolidation. Indeed, the benefits of strong adjustment are highlighted in the medium-term scenarios annexed to the staff report.

Deficit reduction will require a widening of the tax base through a broadening of coverage of indirect taxes and a strengthening of tax administration, as planned by the authorities. On the expenditure side, there is a need to reorient the composition away from unproductive spending to infrastructure and social sector spending, especially on health and education, given the persistent weakness of indicators in those areas. The authorities should pursue with determination a reduction in subsidies, particularly given that cost recovery in the provision of government services is low. In this regard, I welcome the issuance by the government of a discussion paper on subsidies, which, by promoting public debate, will facilitate efforts in this area. In addition, a reduction in civil service employment will be necessary, and the government will have to make an effort to forge a broad consensus among the populace that such changes are inevitable and necessary. The point needs to be brought across that the role of the state is changing in India (as it is elsewhere) and that this is in the long-term interest of the country. Moving forward boldly in the area of public enterprise reform, including disinvestment, and addressing the fiscal imbalances at the state level are also critical elements in strengthening the overall public sector fiscal balance.

The supply response from the structural reforms implemented thus far has been strong, but needs to be reinvigorated through further reforms as supply constraints are beginning to impede growth. Indeed, the staff notes that the recent slowdown in export growth may be related to the incomplete nature of the reforms, including only partial trade liberalization. With regard to the latter, tariffs should be reduced to international levels and quantitative restrictions on imports of consumer goods should be phased out rapidly. Trade liberalization should be accompanied by reforms aimed at increasing labor market flexibility. Indian firms are subjected to excessive employment regulation, thus imposing a heavy burden on firms as they try to become competitive internationally.

As is the case in many other countries, India has gradually come to the realization that the private sector is better placed to own and manage commercial assets. As a result, the disinvestment process in India has begun, but remains politically difficult as suggested by the slow pace of the process. The pace will need to accelerate as part of the overall structural adjustment and private sector development that is under way in India.

Reducing the degree of government involvement in commercial banking is particularly important. While there has been a trend toward bank disintermediation (in favor of equity and debt markets), banks are still a dominant source of finance for enterprises in India and therefore crucial to ensuring a mobilization of savings for investment purposes. With an increasingly competitive environment, however, the banking sector needs to be reformed further, both in terms of regulatory and prudential norms and as regards the strengthening of the role of commercial incentives.

I agree with staff that India should start moving toward capital account convertibility, but this will need to be phased in tandem with other reforms, especially those in the banking sector. In this regard, I found the report of the Committee on Capital Account Convertibility quite interesting, and I share many of the views expressed therein. I am impressed by the authorities' open and transparent approach in this process, as exemplified by placing the Committee's report on the government's web site.

If India pursues its structural reforms with vigor and determination, its long-term prospects are bright. A more immediate issue, however, concerns the stance of macroeconomic policy in the short term. The recent slowing of economic growth has prompted the authorities to implement tax cuts and ease monetary policy. However, to the extent that the slowing in growth reflects the partial nature of structural reforms, such an easing of policy could quickly translate into higher inflation as supply constraints become binding. We would therefore caution against providing the economy with extra stimulus. Indeed, as the staff notes, the authorities should stand ready to tighten financial policies in a preemptive manner should inflationary pressures begin to emerge. I am encouraged by Mr. Sivaraman's assurances in this regard. I also thoroughly agree with staff that, in the context of increasingly open capital markets, the flexibility of the exchange rate should be increased. By allowing a nominal appreciation in the face of capital inflows, greater exchange rate flexibility offers the authorities a tool for managing such inflows. I understand the authorities' desire to avoid excessive real exchange rate appreciation in the event of capital inflows, but this is best done by accelerating fiscal tightening and trade liberalization.

With these remarks, let me wish the Indian authorities further success as they guide their country toward a market-based economy.

Mr. Autheman made the following statement:

Let me say at the beginning that I am closer to the staff appraisal which contains the proper note of caution than to the executive summary which is a little more buoyant in its tone. It is always useful to a have an executive summary, but it leads somewhat to the result that, in the end, we have two staff appraisals. This is not a criticism of an interesting and well-written report.

If India's sustained commitment to economic modernization since the beginning of decade is quite remarkable, it should also be noted that reforms have fallen short in several crucial areas over the recent years; and the impulse of the first wave of reforms adopted after 1990 has been tapering off. In this regard, the results in recent months remain mixed. Some important breakthroughs have been achieved, especially the opening of the prospect of capital account liberalization, but in other areas reforms are still badly needed; and I would especially stress the need to restructure and reduce large and ineffective subsidies.

As for the short-term prospects of the Indian economy, I would be slightly less confident than Mr. Sivaraman or the staff. The recent slowdown may be related to bottlenecks in the economy which are the consequence of delayed reform, and the risk that some inflationary pressure may built up should not be underestimated.

As regards fiscal policy, I am a little concerned by the stance taken by the authorities. The lack of fiscal adjustment has an increasingly negative impact on the real economy. The crowding out of private investment remains substantial, in view of the high level of real interest rates since mid-1996, about 15 percent for average commercial borrowers. The mainstay of the authorities' strategy for 1997/98 consists of significant tax and tariff cuts that are expected to be offset by a combination of increased tax compliance and better economic prospects. As the staff notes in the supplementary note, these conventional supply-side dynamics do not appear to work very well; and there is a risk that far from leading to an improvement of the fiscal position, this recent stance may further weaken it. Indeed, I think that it would be misleading to expect that the supply side of the economy can be strengthened through traditional demand management. Like Mr. Bernes, I would rather rely on more action on the structural front.

The issue of public subsidies is particularly illustrative of the magnitude of the challenge. The Indian authorities themselves have recently issued a remarkable paper which shows that total subsidies for FY 1994/95 reached 14.4 percent of GDP, a level which was equivalent to that of total tax revenues of the consolidated public sector. The same report estimates that about 11 percent of GDP of public subsidies consists of so-called nonmerit subsidies, as opposed to those which have clear direct economic or social justification. I would, therefore, continue to stress that this area should remain the priority for further reform.

As for monetary policy, I would join those who would argue that greater caution may now be needed, taking into account the recent development of short-term flows. I would also like to express my doubt as to whether the decision to eliminate the Reserve Bank of India's automatic financing of government deficit through the issuance of ad hoc treasury bills leads to a real change. It appears that the new mechanism maintains the possibility of central bank financing of fiscal deficit on request; so there appears to be a change more of instrument than of policy.

To conclude, while acknowledging the sustained growth performance of India during the recent years, I would like to encourage the authorities to act with greater resolve, both on the domestic and on the external front by putting greater emphasis on privatization and trade liberalization.

As for the specific issue of capital account liberalization, I share the views of Ms. Lissakers as well as those of Mr. Bernes.

Mr. Shields made the following statement:

India has made significant progress in recent years in orienting policy in the right direction, but much remains to be done if the economy is to match the performance of its neighbors. Most of the staff's policy recommendations are sensible, in terms of both content and priorities. The main areas in which my views differ from the staff's were taken up in Ms. Lissakers's statement.

I agree with Ms. Lissakers that the authorities' announcement of plans to liberalize the capital account is to be welcomed. The authorities should proceed rapidly to implement those plans. While sequencing is important, the authorities should not be under any illusions that every detail can be worked out in advance of liberalization. As Ms. Lissakers mentioned, bumps along the way are inevitable. One of the advantages of greater liberalization is that in the short run it could ease some of the current upward pressure on the exchange rate. Eliminating controls on nonbank outflows and allowing greater freedom for the exchange rate itself would facilitate such an outcome. I can also associate myself with Ms. Lissakers's comments on the financial sector and trade liberalization, and with her queries about credit growth.

The recent data reported at the outset of today's discussion reinforce the staff's recommendation that subsidiary fiscal measures should be prepared by the Indian authorities, and certainly that an adjustment to the oil prices—say, of 15 percent—is overdue. In the medium term India should look to more ambitious fiscal goals, with one obvious route being stronger action to reduce subsidies. In that regard, I would welcome comment from the staff or Mr. Sivaraman on the fertilizer subsidy, and on the expert panel's envisioned timetable for the elimination of that subsidy.

Further on the fiscal side, I support Ms. Lissakers's comments on the composition of spending and on the importance of increasing the size of the tax base. Mr. Autheman's remarks on public enterprise reform were also vital.

I concur with Mr. Mirakhor that, although political considerations may influence the pace of reform, too slow a pace of adjustment and reform in critical areas risks asserting a serious drag on overall macroeconomic performance, and could undermine the attainment of the authorities' high-growth and poverty-reduction objectives.

Mr. Ono made the following statement:

Let me begin by congratulating the authorities on the impressive performance of the economy in recent years. Although there has been some slowdown in industrial output and in exports, it is encouraging that GDP is still expected to grow by more than 6 percent this year. I would like, therefore, to commend the authorities on their appropriate macroeconomic policy. At the same time, I would emphasize that the recent good performance of the economy is largely attributable to the structural reforms initiated in the early 1990s. I think it is particularly important for the new administration to step up its reform efforts in order to assure further development of the economy in the next century.

One of the authorities' top priorities is fiscal consolidation. In this regard, it is welcome that they have set a specific target of reducing the central government's deficit to 3 percent of GDP by the turn of the century. However, there seems to be some uncertainty about whether the current revenue measures are strong enough to achieve that target. I would urge the authorities to make the utmost effort to enhance revenue through measures such as broadening the tax base, strengthening the tax administration and eliminating exemptions. That said, it would be prudent to be ready with possible contingency measures (as a second best solution) in the event that revenues are less buoyant than the authorities anticipate.

In addition, given that the states' fiscal problem constitutes the core of India's fiscal imbalance, there is also a pressing need to curtail the deficit at the state level. To this end, the staff's recommendation that the authorities enhance incentives for fiscal adjustment by increasing the states' responsibility for raising their own financing and then exposing them to greater financial market discipline, is worth considering.

As for the conduct of monetary policy, the gradual monetary easing by the Reserve Bank of India is appropriate. However, given that the liquidity level of the banking sector is already high and that the steepening yield curve suggests rising expectations of inflation, a further loosening of monetary policy cannot be justified.

Looking ahead, an appropriate macroeconomic policy mix might be the most prudent course, that is to say, removing the "fiscal premium" from long-term interest rates by sketching out a plan for achieving the above-mentioned fiscal consolidation target, while keeping a cautious stance on monetary policy.

As for exchange rate policy, this chair welcomes the authorities' readiness to adopt a more flexible approach to exchange rate management.

With regard to structural reform, I share the staff's concern about the authorities' preference for a gradual or partial approach to major structural reforms such as trade reform, public enterprise reform and restructuring of the financial sector.

As the staff mentioned, recently there have been signs that the growth momentum is slowing. I understand there is controversy about which factor—the supply side or the demand side—is dominant for losing the growth momentum. However, assuming that the economy continues to grow at a rate as high as 6 percent, even if supply side constraint is not yet crucial, the problem, will undoubtedly become serious sooner or later. Accordingly, it is important for the authorities to deepen their structural reform efforts in a forward looking manner to ensure sustainable growth in the medium and long term.

It is regrettable to see that a number of exchange restrictions remain in place. In order to encourage stable, long-term foreign direct investment, I join the staff in urging the authorities to eliminate these restrictions as soon as possible.

As for capital account convertibility, I was surprised to learn that a government-appointed committee recently issued a strategic report. The authorities' intention to move toward capital account liberalization is most welcome. As the staff correctly emphasized, the key to success of capital account liberalization without confusion is that capital account restrictions need to be phased out in close step with other areas of reform, namely trade liberalization and reform of the financial sector. I strongly hope that the authorities will promote capital account liberalization in a steady and orderly way in tandem with the structural reform of other areas. with these remarks, I wish the authorities further success.

Mr. Al-Tuwaijri made the following statement:

The Indian economy has made important progress on a number of fronts since the early 1990's. The adjustment and reform efforts resulted in strong growth, lower inflation, and higher reserves. This welcome performance notwithstanding, emerging capacity constraints as well as a slowdown in industrial production and exports highlight the need for vigilance in the period ahead.

Fiscal consolidation is clearly a priority. In this regard, it is important for the authorities to monitor developments in 1997/98 closely and to implement any necessary measures, to ensure, full compliance with the budget. This is especially relevant in view of the staff's indication that there is a risk of a shortfall in revenues. While the reductions in income tax rates and customs duties should enhance efficiency and spur growth, it is necessary to ensure that any revenue loss is offset by broadening the tax base. On the expenditure front, scope exists for savings by better targeting of subsidies. This should allow for the needed investment in infrastructure and education without undermining the expenditure stance.

Success in fiscal consolidation also depends critically on improving the finances of the states. In this regard, it is encouraging that a few states have started the process of fiscal reform. It is important for the central government to use its leverage to encourage an acceleration and extension of this process. Privatizing and restructuring of public enterprises will also contribute to fiscal consolidation and enhance growth prospects. The objective of reviving the disinvestment program is reassuring. I am also encouraged by state governments' efforts to restructure their electricity sectors.

A strengthened fiscal stance will improve the policy-mix and facilitate the conduct of monetary policy. The ongoing financial sector reform will also improve the effectiveness of monetary policy and, enhance resiliency to external shocks. Accelerating efforts in this area is especially relevant given the ongoing integration of India into the global capital markets as evidenced by the increasingly large capital inflows. In this regard, the more flexible exchange rate approach adopted by the authorities is a step in the right direction. Faster pace of trade liberalization and easing restrictions on capital outflows will also help in addressing this issue. Here, I welcome the authorities' intention to move toward capital account convertibility.

With these remarks, I wish the authorities further success.

Mr. Esdar made the following statement:

There is no doubt that India has the economic potential to join the other Asian Tigers in becoming one of the engines of the world economy. The structural reform program which was started at the beginning of the Nineties has opened a promising window of opportunity reflected in high growth rates, strong private capital inflows and a general favorable export performance. Indeed, as Ms. Lissakers has put it, India has set its economy on a new course of modernization which deserves our commendation.

However, there are signs that this process is losing its dynamics. The discussions between the Indian authorities and staff concentrated on the appropriate strategy to react to this situation.

I am concerned that the immediate policy reaction focusing on macroeconomic stimulation favored by the authorities will prove to be inappropriate or even go into the wrong direction. I doubt whether fiscal or monetary fine tuning and short-term stimulation can generate a lasting growth performance with growth rates around 6 percent. To the contrary, I very much share the view of staff that a more ambitious fiscal consolidation effort would encourage a crowding in of private initiative not at least due to its effects on real interest rates. Also, like staff, I am concerned that the substantial—and for efficiency reasons certainly well-targeted—tax reductions are not adequately financed by expenditure cuts. This might increase the fiscal imbalances even further. There is a lot of evidence not only in emerging economies but also in major industrial countries that it may be an illusion to expect that the tax reductions will finance themselves because of their positive effects on growth and also because they tend to reduce incentives for tax exemptions. These Laffer-effects materialize, if at all, only in very specific situations. The recent budgetary data do already reflect those concerns.

Further on tax reform, it is striking that the revenue/GDP ratio in India is only around 11 percent, i.e., relatively low in comparison to international standards. While I generally favor the positive effects of reducing direct taxes on private investment, I wonder whether there would be some room for offsetting increases of indirect taxes.

On monetary policy, the current steepening of the yield curve and the rising commercial bank excess reserve holdings strongly advocate a cautious approach for monetary policy. The exchange rate anchor makes monetary policy even more difficult as continued private capital inflows contribute to a weakening of the monetary stance. Against this background, we fully support staff's recommendations to follow a more flexible exchange rate policy in order to strengthen monetary policy with the objective to bring inflation further down.

In a nutshell, in our view, the macroeconomic environment provides no room for further fiscal or monetary stimulation. The most important contribution of macroeconomic policies under these circumstances would be to provide a stable and predictable environment for private investors by further reducing the public deficit, and by strengthening the effectiveness of monetary policy through greater exchange rate flexibility.

Coming back to the question of how to maintain and strengthen the momentum of growth, in our view, crucial emphasis has to be given to accelerating and broadening the process of structural reform. The staff in this regard mentions a broad range of areas which deserve particular attention. This is also confirmed by the very illustrative background papers which discuss the experience of selected east Asian countries. I can in general endorse those recommendations, especially to further strengthening the financial sector, accelerating trade liberalization, reducing governmental intervention, bureaucratic obstacles and red tape, and generally streamlining the public sector and public enterprises including privatization.

I am encouraged by Mr. Sivaraman's statement that his authorities will continue to concentrate on these areas in order to further open and streamline the Indian economy. The forward-looking proposals of the Committee on Capital Account Convertibility indeed reflect the spirit to reform and open the economy. In so far it was disappointing that the negotiations with the WTO obviously did not reflect the same spirit.

There is one issue which in my view deserves particular attention. I was very much surprised by the extremely low rate of private investment inflows. While staff in its paper discussed some elements which contributed to this disappointing performance, I am not sure whether these findings are sufficient to explain the whole picture. I would be grateful if staff could provide some additional information. In my view, private direct investment inflows have proven to be one of the driving forces for growth in other Asian emerging economies. Therefore, it would be crucial to carefully study the reasons for any shortcomings in the Indian context and to react accordingly.

Mr. Coumbis made the following statement:

The performance of the Indian economy since the early nineties is impressive, with rates of GDP growth close to 7 percent, inflation under control, and the current account deficit at levels close to 1 percent of GDP. A wide range of structural reforms in the early 1990s and a very strict monetary policy are the basic causes of these accomplishments. According to the staff the response of the Indian economy to the structural reforms surpassed all expectations. In our statement last year we stressed that "India is poised for further growth which can be both fast and stable provided that progress continues toward a more efficient use of resources through greater reliance on markets and competition as opposed to direct controls and intervention fostered by public policy." We continue to believe in this statement, taking into account the determination of the authorities to continue the structural reforms and macroeconomic adjustment of the economy.

The targets that the authorities have set with respect to growth and inflation are ambitious and rightly so. Thirty-six percent of the population was below the official poverty line in 1993 and 1994, and the only way to improve the situation is rapid non inflationary and sustainable growth.

The staff has indicated many areas where structural problems have not yet been tackled or have not been faced decisively. Moreover, government deficit is still uncomfortably high, although the government debt has been stabilized. It seems that progress toward fiscal consolidation has been very slow. Thus, the consolidated public sector balance decreased from 12 percent in 1990–91 to 9.5 percent in 1992–93, but since then it has remained at around 9 percent with a jump in 1993–94 and a small reversal in 1996–97.

It seems that the delays in structural reforms and in fiscal adjustment have affected the rate of growth of the economy in 1996–97. In fact, while the GDP rate of growth was only slightly affected, industrial production is estimated to have decelerated to around 7.5 percent from 11.5 percent the previous year. Investment growth appears to have decelerated substantially, and export growth decreased to 4 percent from 21 percent in 1995–96. The authorities argue that there were special factors from the demand side justifying these decreases in various sectors of the economy. While I agree to a certain extent on the existence of special factors, I found the staff's arguments about the effects of the delays of structural reform on the various sectors of the economy in 1996–97 rather convincing, and the recent data provided by the staff further supports this argument. In fact, high public sector deficits absorb financial savings and contribute to high real interest rates. Structural problems in the financial sector have contributed to high intermediation rates and to a reluctance to lending by commercial banks. Weak capital markets and infrastructure bottlenecks, especially in ports and on roads, have affected both investments and exports, and, finally, serious delays in trade liberalization and slow restructuring in the small-scale sector, which accounts for about half of all exports in the traditional sector and which lacks access to credit and capital markets, may have seriously affected exports.

The staff has presented the well known arguments on the adverse effects of high fiscal deficits on the rate of growth in Box 3 in the staff report. Furthermore, the conclusions of the first study in the selected issues paper on the virtuous circle of growth and saving, "Lessons from Selected Asian Countries," indicate the beneficial effects of strong fiscal adjustment. One of the most important factors that distinguishes the four Asian tigers (Thailand, Malaysia, Korea, Indonesia) from India is fiscal consolidation, which was much more extensive and front-loaded in these countries than in India. As a result, the revenue to GDP ratio was and still is much higher than in India, although tax rates in India, at least until recently, had been higher than in these countries. Moreover, the structure of public spending had changed in favor of productive expenditure and away from expensive subsidies. An idea of the size of fiscal consolidation attained in these countries is presented in this study in the case of Malaysia—the only country for which there is data on the consolidated public sector—where the deficit declined from about 15 percent of GDP to 7 percent in three years, and to 2 percent in another four years. All these accomplishments were succeeded without compromising the poverty alleviation and income distribution objectives.

There is no doubt that all this is well known, since numerous studies so far have analyzed extensively the accomplishments in these countries. Last year in our statement we said that "the road ahead for India is clear to see, though not easy to follow." It seems that, in fact, political realities and different social structures in India make it difficult to follow the speed of the adjustment process of the Asian tigers.

This does not mean that we are underestimating the efforts the authorities are making on all fronts or the results obtained so far. We are simply saying that the authorities must increase their efforts in order to meet the challenge of high rates of growth necessary to alleviate poverty in their country.

Another study in the selected issues about the fiscal problems of the states gives a clear picture of the special difficulties that the authorities are facing in their efforts to reduce budget deficits. The fiscal situation of the states has worsened since 1980–81 to the present with respect to the structure of their expenditures—total deficit has not deteriorated. It seems that the states undertake more than half of general government expenditure, but collect only about one-third of general government tax revenues Furthermore, it seems that since 1980–81 wages and salaries, interest payments, and subsidies to consumers and loss-making state enterprises have absorbed an increasing share of stagnant resources. As a result, expenditure on social services, infrastructure and maintenance—nonwage expenditures—had to be cut back. It should be noted that efforts by the states to reduce unproductive expenditures have so far had limited success. I agree with the staff that a lasting solution to the states' fiscal problems will require an overhaul of fiscal relations between the center and the states.

It should also be noted, however, that a number of states have already begun to take encouraging steps toward more comprehensive fiscal reforms. We hope for an acceleration of this process. The center also has plans to improve the financial relations of the center with the states by basing the sharing of central government revenue with the states on a single divisible pool. The problem with this measure is that a constitutional amendment is required.

As for the 1997–98 budget, the short-term and medium-term stabilization policies, and the structural reforms during this period, I am in agreement with the staff's suggested policies, downside risks and contingency measures. I should like, however, to stress the fact that the authorities are committed to take additional measures in order to protect the central government's deficit target, if the tax revenues fall short of the target or if the disinvestment receipts should not be achieved. The authorities also indicated that if there were signs of increasing price pressure, they would tighten their macro policies.

I would also like to stress a recent change in the area of monetary and credit policy that would enhance the autonomy of the reserve bank and strengthen its control over monetary policy. The reserve bank has eliminated the automatic financing of the government through the issuance of ad hoc treasury bills: from now on the reserve bank will provide credit through advances subject to a fixed cumulative ceiling.

With these remarks I wish the authorities much success.

Mr. Kiekens made the following statement:

India's recent economic performance remains good: high growth during the last three years, no signs of a significant rise in inflation, and a strong external position. But as Mr. Sivaraman points out in his written statement, "compared with the performance of the neighboring East Asian economies, which have shown an average growth of over 8 percent, India's performance has room for improvement." Moreover, with 36 percent of the population living below the poverty line, it is imperative for India to achieve higher growth rates.

The main obstacles to a faster improvement in living standards and even better results in the struggle against poverty are the very high public sector deficit and the length of the unfinished structural reform agenda.

I will first comment on the fiscal stance. A deficit of 9.2 percent of GDP, or maybe even 9.4 percent, remains a serious obstacle to growth. It depresses domestic savings and investments, and prevents India from realizing its full growth potential. It hinders growth through high lending rates. Real commercial prime rates hover above 11 percent, on top of which most commercial borrowers have to pay risk premiums of 3–4 percent. Such rates, caused by the large domestic borrowing requirements of the government, and also by the weakness of the banking system itself, obviously discourage investments. Finally, high fiscal deficits create doubts about future macroeconomic stability and are a drag on financial reform and capital account liberalization.

The main task is thus to reduce the fiscal deficit substantially. The gradualistic approach used till now has not produced encouraging results. Let me briefly review last years's budgetary outcomes, both for the central government and for the consolidated public sector. I will then turn to this year's budget.

Last year's central government budget aimed at reducing the deficit by an unambitious 0.5 percent of GDP. But the most recent data indicate that probably only half of this goal was realized, mainly due to a shortfall in privatization revenues and supplementary military expenditures. Those shortfalls and increased expenditures were only partly offset by cutting public investments and postponing civil service salary increases (the Pay Commission award was postponed until next year).

For the consolidated public sector, last year's deficit did not decline from 9 to 8.5 percent of GDP as anticipated, but instead increased to 9.2 or even 9.4 percent, taking account of the staff's revised estimates for the central government. All in all, the consolidated budget deficit is still at the same level as five years ago.

The budget outlook for the FY1997/98 is no more reassuring. For the central government, a further deficit reduction of 0.5 percent of GDP is budgeted. However, 0.4 percent of this reduction is supposed to come from higher privatization revenues which are one-time revenues and, according to the staff, may not fully materialize. The authorities hope that the tax cuts will improve tax compliance and thus produce higher tax revenues. But the experience of other countries that have reduced tax rates to collect more revenues does not indicates that this is always the case. The Indian authorities have taken few measures to expand the tax base, and their projections assume that improvements in the tax administration will produce quick results. I noted with concern that the staff estimate suggest that the tax revenues could fall short of the target by as much as 0.5 percent of GDP. Moreover, a main element for reducing this year's central government budget is the reduction of the net transfers of resources from the central government to the states by 0.4 percent of GDP. Although this measure is welcome, because it strengthens the financial responsibility of the states, it only shifts the burden of the fiscal adjustment from the central to the regional level.

For the public sector outside the central government, an additional 0.5 percent deficit reduction is planned, which would come from a 10 percent increase in the average petroleum price by mid 1997. The staff's information, released yesterday, that no such decision has yet been taken, therefore causes concern. I wonder if Mr. Sivaraman could inform the Board further.

There appears to be ample room on the revenue side to increase the ratio of taxes to GDP. Indian tax revenues are very low: gross revenues, including the states' share, amounted to only 10.6 percent of GDP in 1996/97. This level is virtually unchanged since 1992/93.

The composition of expenditures is a constant cause for concern. Interest payments and defense spending absorb 88 percent of the central government's tax revenues, leaving little room for productive and social spending. I also regret that the authorities see little political room to reduce food and fertilizer subsidies anytime soon, but I commend the government for organizing a public debate on the effectiveness of the subsidies by distributing a white paper and a report of a panel of experts. I regret that the Board did not receive a functional classification for the expenditures in this year's budget.

For all these reasons, I join the staff in urging the authorities to design and implement a faster, more ambitious fiscal adjustment program, which would increase revenues by broadening tax base and curtail unproductive expenditures and low priority spending. Additional measures are needed to achieve the deficit target. Since the states are responsible for a substantial part of the deficit, equal attention will have to be paid to reducing their imbalances. To that end, they should become more responsible for their own financing, and should be exposed to market discipline.

Let me now turn briefly to the monetary policy and structural reform. Concerns over the sharp deceleration of industrial output growth, caused by the monetary tightening of FY1995/96, has led to a loosening of monetary policy last year. This, combined with continued surges of capital inflows, could easily generate excessive demand pressures leading to macroeconomic instability. Since broad money growth exceeded the Reserve Bank of India's announced targets, increased vigilance is recommended.

When I began, I noted that the lengthy unfinished agenda of structural reforms is one of two most important obstacles to economic growth. The staff report convincingly demonstrates the complementarity of fiscal consolidation and structural reforms, and the need for their mutual reinforcement. The staff also identifies the areas where structural reforms should be accelerated. I do not need to repeat them here, but will just emphasize that accelerating privatization, strengthening the soundness of the financial system and accelerating trade reforms are essential for ensuring sustained high growth without jeopardizing macroeconomic stability.

Mr. Mirakhor is well placed to appreciate the difficult task of the large democracies in the region in marshaling the political forces necessary to initiate economic adjustment and reform. At the end of his excellent statement, he concludes that in India this has already been accomplished with considerable skill and success. I certainly agree with this, but would like to underline that the Indian authorities must continue to display the same skill and persistence in order to realize India's great potential. I wish them every success in doing so.

Mr. Shaalan made the following statement:

As noted by previous speakers, in many respects, the economic performance in India has been strong. In the fiscal year that just ended, real GDP maintained its brisk pace of recent years, the external current account deficit was modest, and inflation, though still high, appears to have stabilized at the single digit level. This record represents a noteworthy turnaround following the reforms that were introduced in 1991 and pursued thereafter. It is now important that policies be geared to sustaining this record and enhancing the growth potential of the economy. The deceleration in the growth of industrial production, investments, and exports suggests the need for a redirection of economic policies. In this connection, a strengthening of the public finance stance, as well as structural reforms in certain key areas identified in the comprehensive set of staff papers before us, are called for.

First, on fiscal policy. We welcome the steps taken in the context of the 1997/98 budget. These are spelled out in Mr. Sivaraman's most helpful statement; in particular the cuts in tariffs and income taxes are noteworthy. Like Mr. Esdar we would have favored offsetting measures through cuts in expenditures. It now appears from the staff supplement that additional measures may be needed to achieve the deficit target for the year. In this regard, we fully concur with the menu of options provided by the staff and caution against expenditure cuts that could affect growth adversely.

Like Mr. Kiekens about the size of the overall public sector deficit which is in excess of 9 percent is a source of concern. A deficit of this magnitude has necessitated the maintenance, until recently, of a tight monetary stance. This policy mix, i.e., high public sector deficit coupled with a tight monetary stance, if maintained, could well constrain the economy's growth capacity through not only the negative impact on public sector savings but also by contributing to high interest rates—a factor that could be a deterrent to private sector investments.

Accordingly, more emphasis should be placed on further consolidation of public sector finances to permit an easing of interest rates without endangering price stability. In this connection, we welcome the authorities' medium-term target of reducing the government deficit to 3 percent by the end of the decade. Here we would underscore the importance of addressing fiscal imbalances at the state level through strengthened expenditure management and reforming the current system of transfers between the center and the states. I found the background paper on state finances extremely useful and timely. With regard to public sector enterprises, a greater degree of financial discipline to reduce the drain on the budget appears to be called for. In this connection, privatization should also be accelerated. Further fiscal consolidation will create room in the budget for needed outlays on physical and social infrastructure to underpin a faster and sustainable rate of growth. The fiscal consolidation should address and rationalize the high level of subsidies that permeate the economy.

Turning to monetary policy, we welcome the recent change in the government's automatic access to the Reserve Bank of India credit, which placed a fixed cumulative ceiling on its credit to the government. Given the continued expansionary fiscal policy, it would not be appropriate at this point to ease monetary policy to stimulate economic growth. Until fiscal policy can substantially contribute to the stabilization effort, it is important that monetary policy remain firmly focused on controlling inflationary pressure. In this connection, we share the staff concern that if short-term rates are not raised, credit growth might increase to undesirable levels.

On the real sector, a comprehensive and well-structured privatization program, accompanied by further trade liberalization and banking sector reform, would improve the confidence of domestic and foreign investors which is essential to maintaining and stabilizing growth in the economy. In addition, the privatization program would make a major contribution to controlling the public enterprises budget and to improving efficiency in the economy.

On the external sector a more appropriate financial policy mix would permit the introduction of a flexible exchange rate policy. This would need to be complemented by further trade liberalization. On capital account liberalization, we endorse the measured steps announced by the Reserve Bank of India, measured so as to prevent any backsliding. A smooth transition to capital account liberalization will require not only the pursuit of appropriate financial policies but also a resilient banking sector.

India has had a good record of economic performance in recent years. We are hopeful that the policies pursued will continue to enhance this record. We wish the authorities every success.

The Executive Board recessed at 1:00 p.m. and reconvened at 2:35 p.m.

Mr. Mozhin made the following statement:

Let me, first, thank the staff for a very informative and well-written set of papers. I share the staff's assessment that India has already achieved a very significant progress on the road of its economic transformation. I also agree that the Indian government still faces formidable challenges in its efforts to untangle the web of administrative controls that for many years have substituted market signals. As Jagdish Bhagwati, a well known expert in the Indian economy, wrote in the *Financial Times*, "The question now is not whether the reforms will be reversed but how rapidly they will be extended."

Indian political circumstances are such that in order to maintain the pace of the reform process, the government needs to maintain the growth momentum. If the authorities are able to demonstrate visible progress on the growth side, this will strengthen the social consensus on the benefits of the deep economic transformation. In recent years the growth rate has been rather impressive and, as Mr. Sivaraman reminded us, averaged about 6.5 percent. I agree with the authorities that at this juncture the economy needs a second wave of buoyant growth. I hope that the steps recently undertaken by the authorities on both demand and supply sides will work. We have already seen some early signs of growing market confidence, as evidenced, in particular, by the recent advances in the stock market and an increase in capital inflows.

Obviously, the economic situation remains very delicate. The authorities can not afford to take chances and put the macroeconomic stability at risk. The decision to ease the monetary conditions in order to stimulate the economy could be seen as increasing such risk. At the same time, I certainly understand the authorities' desire to bring down real interest rates which are, indeed, too high in India. Perhaps, the authorities' decision to broaden the access for Indian companies to cheaper long term borrowing from abroad could bring about a flattening in the yield curve, as well as provide the authorities with somewhat more room for maneuver in their monetary management. Hopefully, Indian companies will be able to benefit from the current buoyant demand for emerging markets' debt.

As for the danger of new inflationary pressures, I agree with the staff that we have to trust the judgment of the Indian authorities and, at the same time, to urge them to closely monitor the developments. Mr. Sivaraman's assurances and India's track record in recent years make me believe that, if needed, the authorities will not hesitate to step in with corrective measures. Let me also mention that, as a result of significant structural reforms undertaken over the last couple of years, there seems to be a considerable uncertainty with respect to India's potential output.

The authorities should be commended for their efforts to improve infrastructure through more active participation of the private sector. This, together with other supply-side oriented measures, such as the reduction in marginal tax rates and the ongoing liberalization of the foreign trade, are likely to reinforce India's growth potential.

The complexity of the fiscal situation is well described in the staff report and the selected issues paper. I will not repeat the points made there and by previous speakers. Let me just mention for the record, that I share the staff views on that subject. Despite some positive developments in the fiscal area, it is difficult to overestimate the urgency of significant further progress.

Recently we have seen some unfortunate delays in the long-overdue revision of the prices in the hydrocarbon sector. It is well known that the administered price mechanism is distortive as well as expensive. The example of the diesel price which is only about one third of the average prices in the neighboring countries, and today is responsible for the largest chunk of subsidies in the hydrocarbon sector, is a good illustration. According to the staff, there have been several studies that addressed specific issues of this sector in some details. The authorities can also make use of the "R" report, which seems to be a rather specific, if incomplete, action plan. Although I recognize the political sensitivities, I would still urge the authorities to speed up their efforts in eliminating the largest distortions in the economy.

We will certainly closely follow the implementation of the plan to introduce capital account convertibility over the next three years. Since the sequencing of the measures and coordination with other structural changes will largely determine the success of this plan, its very announcement is quite important, as it may well provide an additional impulse for further reforms.

Mr. Wijnholds made the following statement:

First, I would like to commend staff on the papers. Three years of experimenting with the format of the reports on India has resulted in frank reports which stimulate pointed and fruitful discussions.

Turning to the substance of the report, it is very clear that the authorities have come far since 1991, and are continuing on the same path. But we would not be true to our motto if we would allow for complacency. Certainly, the cautious approach advocated by the Indian authorities is understandable given the uncertain political climate and the diversity of the Indian electorate. But there are also compelling arguments for advocating a more ambitious agenda. One is the fact that even the limited reforms implemented so far have yielded such immediate and positive results. This should make further measures easier to sell. Another is the fact, as Mr. Sivaraman has pointed out in his frank statement, that India's economic performance has room for improvement when compared to neighboring East Asian economies.

A third reason to speed up reforms is the ambitious aim to liberalize capital movements. Indeed, during our previous discussion, this chair argued for more capital account liberalization. At that time, staff rightly pointed to the need for further reforms, to ensure that India would be 'ready' to lift capital controls. But one can also take a different angle. Instead of noting that more reforms are needed before capital account convertibility can be established, one can also argue that reforms can be sped up by dovetailing them with a gradual but steady agenda to remove capital controls. This is how I read the message of the Committee on Capital Account Convertibility. Its report rightly points out that an open capital account in India requires more fiscal consolidation, lower inflation, an independent central bank and a stronger financial sector. Its message is not that capital account convertibility is therefore not an option, but rather that other reforms have to move in line with the aim to liberalize capital movements.

The staff rightly embraces the Committee's message, and elaborates on it. In general, I found that staff strikes a reasonable balance between supporting more liberalization, while being careful to ensure the proper sequencing of reforms. As such it represents a good example of how the Fund can play a more prominent role in this area, as is envisioned in our discussions on an amendment. For instance, staff suggests that trade liberalization and more exchange rate flexibility can help to deal with the problem of large inflows. In addition, staff provides some suggestions for the types of capital controls that should be lifted first. I think this discussion illustrates how capital account liberalization can provide both a reference point and an incentive for reforms. Let me just add two comments to the staff's advice. With regard to exchange rate flexibility, I would add that this requires stronger banking supervision, especially when banks start attracting funds from abroad to lend on domestically. With regard to trade liberalization, clearly the collapse of the WTO negotiations is disappointing. The argument that quantitative restrictions are needed for balance of payments reasons seems hard to defend.

On fiscal reform, I have two comments. First, the size of the deficit clearly puts a brake on growth. The staff has illustrated how some high growth countries managed to free up savings, so that they can be channeled to productive investments. In the case of India, a large chunk of savings is required to cover the fiscal deficit. Granted, part of these resources are used to finance public investment. But it should be noted that the productivity of public investments has been very low over the years. Some estimates have put the yield on public investments some 15 to 20 percent below those in the private sector. In general therefore, it is clear that substantial resources are diverted away from growth-inducing investments. I agree with the staff therefore that sustainable high growth will require a more ambitious fiscal consolidation.

There is some cause for concern in this regard. Growth relies heavily on loose monetary policies and cuts in taxes, while the pace and extent of fiscal consolidation is not very ambitious. At the central government level, the authorities concentrate on improved revenue collection and disinvestment receipts. But the staff report gives the impression that not much has been done yet to broaden the tax base—and the latest figures seem to confirm this. And with regard to the disinvestment receipts, it seems that these are derived to a large extent from selling minority stakes in public enterprises. Obviously, this provides revenue, but it does little to change the ways in which these enterprises are operated.

With regard to the state governments, it might well be that fiscal management at this level will become more important in the future, especially in view of a possible movement toward a more decentralized system of government. If so, the state governments have a difficult task ahead. When the World Bank declared a "crisis of expenditure composition" last year, it was looking at roughly the same composition of fiscal spending as in the current fiscal year. I think this is a message we should reiterate. In this regard, I feel ambivalent about the staff's recommendations to allow the state governments more freedom to borrow. First of all, it seems that our main message should be to cut state subsidies, improve cost-recovery and privatize state enterprises. Secondly, I wonder whether borrowing from the market will actually expose states all that much to market discipline, as staff argues. To start with, this would require a strong no bail-out commitment from the central government. Given the long-standing tradition to write off state debts, I wonder how credible this will be. Moreover, experience with government securities has shown that their yields might be depressed by preferential access. Of course this is a matter of judgment and I may be too pessimistic on this issue, but a word of caution seems in order.

On a final note, let me emphasize that the authorities clearly have accomplished a lot in the last five years. In some ways, India resembles China. Both have a history of deep-rooted and extensive regulation. This is clearly being tackled now, and the indications are that reforms will continue. There are many areas where the need to prevent social upheavals might call for a gradual approach. But there are also numerous measures that can very well be taken now.

Mr. Zhang made the following statement:

We commend the Indian authorities for their remarkable achievements over the previous years as evidenced by strong economic growth, the reduced inflation rate, increased savings and investment rates, and a sound external position. These achievements are largely attributable to the authorities' determined reform and liberalization efforts as well as their skillful economic management. It is particularly worthy to note that the achievement of macroeconomic stability in India has been against the background of the launch of a wide-range of structural reforms to promote dynamic industrial and service sectors and increase efficiency gains.

The excellent staff papers have well documented the current state of the Indian economy and policy paths to address challenges in the future, with which I am in broad agreement. Mr. Sivaraman's comprehensive statement also provided very helpful information. So I would like to make a few points for emphasis.

Like many other developing countries, India is challenged to maintain a stable macroeconomic environment while accelerating structural reform and external liberalization to sustain a high growth rate with low inflation over long-term. In this context, given the recent growth slowdown, the short-term macroeconomic management should focus on how to fine-tune policies. It is essential to avoid an excessive build-up in demand pressures in the process of reviving growth by cutting tax rates and stimulating bank credit growth. I share the staff view that the authorities are urged to monitor inflation developments closely and promptly tighten demand policies when inflation pressures intensify.

Over the medium term, as the staff rightly pointed out, the prospects for sustaining a high growth rate hinge critically on establishing sound public finance and achieving significant progress in structural reforms. A persistently sound public finance can only be achieved by comprehensive measures on both the revenue and expenditure sides, including broadening the tax base and strengthening tax administration, and improving the expenditure composition with increased spending on social and infrastructure sectors. It is equally important to accelerate the restructuring of public enterprises and rationalize the fiscal relationship between the center and the states.

While progress has been made in trade liberalization, achieving a sustained strengthening of the external position calls for the deepening and broadening of trade reform. The authorities are also encouraged to phase out the remaining exchange restrictions at an early stage. Priority should also be given to promoting the soundness of the financial sector and further improving their efficiency in mobilizing savings for investments. While the recent efforts of commercial banks in strengthening their balance sheets are welcome, more efforts should be made to increase autonomy in publicly owned banks and in strengthening their commercial incentives, and to enhance the authorities' prudent regulation and supervision over the banking sector. Also, I would like to associate myself with Mr. Bernes in underscoring the importance of carrying out labor market reform toward increasing labor market flexibility.

We join others in welcoming the authorities' intention to proceed toward capital account liberalization in three years by the year 2000. This is certainly an important and clear signal sent by the authorities to make their economy more competitive and to integrate further with the global economy. To my mind, capital account convertibility needs a strong macroeconomic policy framework and a sound financial sector. Therefore, this objective, as the staff and other speakers have already emphasized, should be realized step by step and complemented by significant progress in other reforms, particularly in furthering fiscal consolidation and strengthening the financial sector.

In conclusion, I wish the Indian authorities all success in their endeavors.

Mr. Joyosumarto made the following statement:

We view the performance of India as impressive and commendable. We have no doubt that India has recognized the path and direction to take and needs to push on to arrive at a social consensus for further progress. The staff has identified the steps that the authorities need to take, and Mr. Sivaraman's statement has also clarified that the Indian authorities are in the process of implementing these and other efforts. As many speakers had also touched on the major issues, I would like to make the following remarks for emphasis.

We believe that the Indian authorities are heading toward the right direction. We welcome the efforts by the authorities to reduce the fiscal deficit through tax reduction, the proposed adjustment in petroleum prices and a dismantling of the administered price mechanism to reflect market prices. I also do support the appraisal by staff that the efforts in the fiscal measures taken by the authorities should be complemented with measures to reduce subsidies, expand the tax base, improve tax administration and "considered reduction" or right sizing in the civil service.

This chair believes that, for the Indian economy to accelerate economic growth in a sustained manner, the authorities need to quicken the pace of structural reforms. The need to liberalize foreign investment regulations, reduce trade restrictions and the maintenance as well as the enforcement of the ongoing financial reform are crucial in the immediate scenario.

The steps that had been taken by the Indian authorities to liberalize the capital account are indeed welcomed. It is also encouraging to note that the authorities do recognize that the liberalization of the capital account will need to be accompanied by other reforms in the financial sector. Liberalization will bring in the necessary funds required by the various investment opportunities. However, India should be cautioned to use these flows wisely as capital flows is a two edged sword and can be detrimental if not used efficiently.

We are in agreement with the staff that exchange rate flexibility will accommodate the Indian economy as it undergoes transformation. Moreover, the enhanced independence of the Reserve Bank of India, greater autonomy, liberalization of lending directives and an exit policy for banks that are inefficient, are all policies in the right direction.

Finally to conclude this chair approves the proposed decision set out on page 35. We would like to wish the Indian authorities all the success in the future in broadening and deepening the Indian economy.

The staff representative from the Asia and Pacific Department noted that the staff had attempted to strike a measured balance in the executive summary of the staff report. The main message of the staff report and the appraisal was that, although the partial reforms that had taken place so far had had a bigger impact on growth and private savings than had been expected a few years ago, major structural problems remained to be addressed, as reflected in the macroeconomic problems that Directors had noted in their statements.

The staff had cautioned the authorities to closely monitor monetary conditions, particularly given that the fiscal targets were unlikely to be met without additional measures, the staff representative remarked. Strengthened prudential regulations had had a temporary effect on the timing and transmission mechanisms of liquidity injections, but the staff did not expect that the overall level of credit expansion would decline. Indeed, banks were currently quite liquid with considerable excess reserves, and short-term interest rates were low, which could pose risks of excess credit expansion. New measures announced in the April 1997 monetary policy statement to increase banks' autonomy in credit decisions—particularly with respect to credit for working capital—would reinforce those trends, as would the recovery in business confidence reflected in forward indicators and the pickup in asset prices induced by the stock market boom. Although the timing was difficult to predict, the staff expected a rapid increase in credit expansion in the year ahead.

The phasing out of the issuance of ad hoc treasury bills had achieved the important goal of eliminating automatic monetization of the deficit, and was therefore a substantial step toward greater Reserve Bank of India independence, the staff representative considered. Under the old system, the reserve bank had been required to finance any shortfall in the preannounced market borrowing plan with low interest ad hoc treasury bills. That system had not only weakened monetary control; it had also eliminated incentives for the central government to manage its own cash position in a more satisfactory manner. The central government was currently in the process of establishing better cash management procedures. The elimination of ad hoc treasury bills needed to be reinforced by further reforms, however, of which the most important initial one would be to move away from government involvement in the primary securities auctions—which was still heavy—with the aim of allowing interest rates to reflect the true costs of the fiscal deficit.

Liberalization of capital outflows should be an early part of the reform process, from the point of view of both potential efficiency gains and the potential impact on the real exchange rate, the staff representative agreed. Indeed, from an efficiency standpoint, no real distinction should be made between liberalizing inflows and outflows. The report of the Committee on Capital Account Liberalization had recommended a bold path of liberalization. If those recommendations were implemented, three years later anyone in India would be permitted to invest overseas $100,000 a year in equity; Indian institutional investors could invest abroad up to a cap of $2 billion; and no prequalifications would be needed by Indian companies for approval of outward foreign direct investment of up to $50 million. Prospects for moving faster, particularly with respect to liberalizing foreign direct investment outflows from India beyond the $50 million ceiling, were closely linked with the increased integration of India's economy with the world economy as Indian companies became more outward oriented. However, the staff viewed the benefits of the committee's recommendations—if fully implemented—as already quite dramatic.

While the staff agreed that domestic and external liberalization should, in principle, move rapidly in tandem, serious risks could emerge if external liberalization were to be undertaken in an environment of stalled fiscal adjustment, a high fiscal deficit, and an overly gradual approach to dealing with weaknesses in the banking system, the staff representative remarked. That combination of events could lead to both external balance of payments difficulties and domestic financial difficulties over the medium term, combined with upward pressure on the real exchange rate and excessive short-term borrowing. The staff viewed that set of circumstances, if mishandled, as the scenario in which India could become vulnerable to a major external crisis in the years ahead.

The domestic banking system was still dominated by the public sector banks, which controlled over 80 percent of total deposits—slightly higher than the share in China's banking system—the staff representative noted. Private sector equity in some of the public banks—particularly in the State Bank of India—had been increasing. However, the government's policy that all public banks must remain majority-owned by the government constrained the extent of improvements in governance that increased private ownership could produce, although some gains had been made.

New entry by both foreign and domestic private banks had been liberalized significantly, the staff representative continued. The number of private domestic banks had increased from 26 to 35 in the past few years, and the number of foreign banks had increased from 24 to 36. Any reputable foreign bank could generally obtain a license to operate in India with relative ease; however, continuing restrictions on branching activities posed the real barrier to entry. Banks interested in opening a branch in an urban area were required to open a corresponding rural branch. All branching activities were also still subject to approval by the reserve bank. Foreign banks in India controlled only about 170 branches out of the 40,000 total branches in India, which naturally constituted a limit on effective competition.

Nonperforming assets of public sector banks had been reduced but still accounted for about 14 percent of total lending, the staff representative noted. That figure did not reflect the total size of bank balance sheets because public sector banks still held large stocks of government securities. At least 2 of the 27 public sector banks were technically insolvent in the sense that their net worth had probably been completely eroded. Insolvencies had declined over the past few years, however.

Strengthening prudential requirements was one element of the government's strategy to deal with banking sector weaknesses, the staff representative remarked. Banks' internal management had improved with the support of a World Bank restructuring loan that focused on six of the weaker banks. Debt recovery had also improved but was still constrained by the absence of an effective bankruptcy and closure policy for ailing firms. Over the previous five years, the government had injected public funds equivalent to roughly 1¾ percent of GDP into the banks. The staff estimated that additional funds would be required; one particular bank, for example, might need a further 0.1 percent of GDP in capital injections.

Much scope existed for broadening the tax base, both on the indirect and direct tax sides, the staff representative said. The most appropriate measure of India's tax effort, compared with that of other countries, was tax collection at the general government level—the central government plus the states—which, in India's case, totaled 16½ percent of GDP. The figures quoted in the staff's opening remarks either included the central government's own effort or the central government's effort less the revenue sharing with the states.

Against that background, the recent tax cuts had not been accompanied by sufficient action to broaden the tax base, the staff representative continued. On the indirect tax side, a move toward a full-fledged, value-added tax at both the central and state levels could be achieved by eliminating the many remaining exemptions and expanding coverage to all sectors—including the service sectors. At the direct tax level, also, many sectors were not sufficiently taxed: the small-scale sector benefited from many exemptions; export income was not effectively taxed; and agricultural income—a state responsibility—was essentially untaxed.

Amnesty schemes to encourage the return of black market money to the formal economy had not been effective in changing the total tax base of the economy in the past, the staff representative noted. If the current amnesty venture was to be more successful, it needed to be accompanied by bold measures to improve tax registration. The government had offered some useful proposals in that regard, including four criteria for identifying people who should be registered for direct taxes—home ownership, car ownership, use of foreign travel services, and telephone use—and were currently developing integrated databases on those indicators with the tax registration database. That effort had just started and had not yet yielded substantial results.

Another staff representative from the Asia and Pacific Department remarked that the white paper on subsidies prepared by the authorities—with the assistance of a Fund staff member on secondment to India—was a useful document, which should be instrumental in developing a consensus within India to try to address some of the issues raised by the existence of large subsidies.

The concept of subsidies used in the paper was a broad economic concept rather than a narrow budgetary one, the staff representative noted. The 15 percent figure cited in the paper for subsidies could therefore not be compared with budgetary estimates of revenues. For example, the 15 percent figure included the cost of below-market rates of return on the investments made by the state and central government in their public enterprises over a number of years. The figure also included cross-subsidies within sectors—for example, within the electricity sector, industry generally paid quite a high tariff. The resources generated by that higher tariff were then fed into the consumer goods sector and into the agricultural sector, which paid much lower tariff rates, so that the net impact on the budget was actually much less.

The paper successfully drew attention to the large distortions involved in the subsidy system, the staff representative continued. The estimate for cost recovery of government goods and services of only 10 percent, including nonmerit goods—that is, goods where no externalities were involved—was striking, and illustrated well the degree to which certain Indian producers were not faced with the true costs of their inputs. Fertilizer, electricity, and certain petroleum products were particularly egregious examples in that regard.

The staff would agree that the subsidy system was not particularly effective in alleviating the burden on the poor, the staff representative remarked. A large proportion of the subsidies were absorbed by the middle and upper classes; expenses on higher education, for example, absorbed 1½ percent of GDP. The food subsidy system was still poorly targeted, although some efforts had been made in 1997 to improve it. A substantial proportion of the subsidies was also absorbed by the industrial inefficiency. About one-half of the fertilizer subsidy, for example, was estimated to be absorbed in paying for the excessive costs of the inefficient Indian fertilizer industry.

The expert panel looking into the question of fertilizer subsidies—which had been set up in January 1997—had been asked to submit its findings by the end of July 1997, the staff representative said. The staff had certainly pressed for the elimination of the fertilizer subsidies.

With respect to Mr. Kiekens's question about the functional classification of central government expenditure, the staff did not yet have that information for the 1997/98 budget, owing to lags in data reporting, the staff representative noted. Functional classification of expenditure for the 1996/97 budget was presented in the background paper on recent economic developments, both in a table and in a chart. The nonavailability of breakdowns of state level expenditures was a long-standing problem which had hampered the staff's analysis of social spending; such spending was particularly concentrated at the state level.

With respect to Mr. Esdar's question about the low amounts of foreign direct investment into India, one should remember that five years previously, India had been receiving virtually no foreign direct investment, the staff representative remarked. A substantial buildup in foreign direct investment had therefore taken place to reach the current level of roughly $2.5 billion. That figure would be higher if one included a portion of the substantial inflows from nonresident Indian investors, which were not well classified within the Indian balance of payments accounts. Even if that adjustment were made, however, the staff agreed that—at ¾ of 1 percent of GDP—foreign direct investment flows were low compared with those of east Asian countries, and also fell short of the government's own objective of raising foreign direct investment levels to around $10 billion a year by the turn of the century.

If one compared the Indian regime with those of east Asian countries, however, the Indian system was not much more restrictive, the staff representative considered. Remaining restrictions in the regulatory framework for foreign direct investment approvals had been further liberalized in 1997 and probably did not constitute the core of the problem. Indeed, over $20 billion worth of approvals over the past two years remained in the pipeline, a substantially larger figure than actual inflows.

Broader factors than the foreign direct investment regime were therefore at play, the staff representative remarked. A large share of the $20 billion in the pipeline, for example, was intended for the infrastructure sector but could not move quickly until the legal, pricing, and regulatory issues discussed in the report had been dealt with. Assuming that progress continued to be made in those areas, one could envision a substantial buildup in infrastructure investment by foreign companies in India over the next five years.

Foreign companies also specified that the lack of a defined exit policy was a major concern with regard to investing in India, the staff representative continued. Reservation policies—the policies that reserve certain sectors, particularly consumer goods sectors, for small-scale enterprises—also effectively prevented the entry of foreign companies, as well as large Indian companies, into those sectors. A range of governance issues were also of concern to foreign companies. Even after a foreign investment proposal was approved by the foreign investment promotion board, a wide range of licences and permits needed to be acquired, both from the central government and from local governments. Much could be done to streamline that process and to increase its transparency.

Mr. Yao made the following statement:

> The excellent set of papers prepared by the staff and Mr. Sivaraman's very informative statement indicate that the Indian economy has continued to perform well during 1996/97. Indeed, real GDP growth, although slowing, was strong, inflation remains under control, and the external position strengthened considerably, with the international reserves being at a comfortable level. Moreover, in the area of structural reforms, several initiatives were recently taken by the authorities aimed at boosting business confidence and investment. I commend the authorities for these achievements, supported by the successful implementation of economic reforms.
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> Although the overall performance of India's economy continues to be quite favorable, I share the view that the main challenges facing the country in the near and the medium term are the need to bring down the still high fiscal

deficit, and to accelerate and maintain a strong economic growth, so as to raise living standards of the population.

Since I am in broad agreement with the staff's appraisal and policy recommendations, I will be brief and focus my remarks on two issues.

First, as regards fiscal policy, notwithstanding the impressive fiscal adjustment achieved over the past years, I share the view that the still prevailing high fiscal deficit constitutes a serious impediment to growth, as government borrowing to finance this deficit would crowd out the private sector. In this regard, I am encouraged by the number of revenue-increasing and expenditure-reducing measures taken recently by the authorities to reduce the central government deficit. However, more needs to be done. I can therefore associate myself with the suggestion that the authorities should adopt additional strong measures, including a stronger fiscal adjustment efforts extended beyond the central government level, in order to ensure the achievement of the fiscal objective and avoid rekindling inflation. Box 4 at page 25 of the staff report clearly shows the magnitude of the fiscal problem in India and the solutions to be implemented. In particular it is quite clear that a successful fiscal adjustment should encompass both the need for a substantial reform of public enterprises and for a strong action to address fiscal imbalances at the state level. In this connection, like Mr. Kiekens and others, I encourage the authorities to implement more forcefully the agenda for fiscal reform which put emphasis on measures designed to broaden the tax base and to improve tax administration, as well as to measures aimed at improving expenditure management and fiscal discipline.

Second, on the issue of structural reforms and poverty alleviation, we share the view that the achievement of a high growth over the medium term will be imperative to make further progress in this latter critical area. In that context, structural reforms should be the cornerstone of the government's strategy. As indicated in the staff paper, the country is confronted with major bottlenecks to growth in the infrastructure sector. Steps taken by the authorities to address these bottlenecks are encouraging and should be pursued. The private sector should also be called upon to play a major role, given that the country has to face with growing budgetary constraints.

Finally, like other speakers, I welcome the authorities' intention to proceed toward the capital account convertibility in the years to come. We have no doubt that the authorities are aware of the implications of this process, which, as stated by Mr. Mirakhor, in order to be successful, should be supported by continued domestic adjustments and especially by the strengthening of the financial system. And, I would also add that the introduction of a flexible exchange rate system is an essential element, if we want to avoid the financial crisis experienced in many countries.

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

Mr. O'Brien made the following statement:

I am very grateful to the staff for a clear and comprehensive analysis of the performance and prospects of the Indian economy. The Indian authorities are also to be congratulated for their courageous management of the economy in the face of complex and daunting social and political circumstances.

The Indian economy has continued to perform quite strongly. Real GDP has grown by over 7.0 percent in both 1994/95 and 1995/96, and an estimated 6.5 percent in 1996/97. At the same time, inflation has been kept at the single digit level, while the external position has remained healthy, and private sector savings have been very encouraging. The central government deficit is being gradually reduced, although the consolidated public sector deficit remains more or less unchanged at a relatively high level. The process of structural reform, though at times slow and uneven in pace, has continued and appears to be gaining momentum.

However, quite obviously, there are very strong and serious challenges facing the Indian authorities. I agree fully with the assessment of the staff that "strong fiscal consolidation and bold reform initiatives are still needed to achieve the authorities' objective of raising sustainable growth to 7–8 percent." This assessment, to my mind, captures and encapsulates the essence of the challenges which face the authorities in achieving sustainable growth.

The staff papers have very clearly sounded the warning that supply constraints posed by inadequate economic infrastructure, particularly power supply, constitute very serious impediments to growth, and that current utilization appears to be very close to full capacity. Given, the very low level of public sector savings and the compression of public expenditure on economic services, the urgency of the need to effect structural reforms which would encourage and facilitate investment, particularly in economic infrastructure, is well underscored. Further, the rather robust supply responses to reforms already undertaken should provide encouragement and support to the authorities in their efforts to gain the necessary consensus and cooperation to complete the reform process. I would also wish to encourage and urge the Indian authorities not to waiver in their commitment to this task.

On the fiscal consolidation front, the relative lack of movement in the reduction of the consolidated public sector deficit must be a cause of serious concern for the authorities. The economy has so far been spared the worst effects of the financing of this deficit because of the strong capital inflows, although, as indicated by the staff, it is already posing a serious constraint to private sector growth. This speaks to the urgency of the need to proceed with the restructuring of the state enterprises sector, and to improve the revenue system. With regard to the latter, the tax measures in the 1997/98 budget are most welcome signs of the commitment of the authorities. The establishment of the Committee to pursue the restructuring of the state enterprises is also very encouraging.

The staff have noted that given the relative inflexibility of the fiscal regime, the burden of adjustment would fall more heavily on monetary policy. In the light of this, the authorities are to be encouraged to proceed with the reform and strengthening of the financial system.

Finally, it is very pleasing to note that the strategies of the authorities for the medium term include policies aimed at boosting business confidence and the growth momentum, while seeking to maintain a framework which facilitates continued moderation of inflation and a secure external position. There appears to be ample evidence of the commitment and courage of the new administration to pursue such policies and I offer my congratulations and encouragement and best wishes for continued success.

Mr. Eyzaguirre made the following statement:

Like other Directors we wish to commend the staff for the very interesting and useful set of papers prepared for today's discussion. I found the paper on "The Virtuous Circle of Growth and Saving: Lessons from the Experience of Selected East Asian Countries" particularly valuable. We also wish to thank Mr. Sivaraman for his comprehensive and insightful statement.

India has made an impressive progress in terms of growth, while maintaining a sound external position and inflation under control since 1991. Since I am in broad agreement with the staff appraisal, I will limit my remarks to highlight the adequacy of the policy mix in the short run, and to comment on saving, growth and structural reforms.

Since the stabilization and reform program started in 1991 there has been a tightening of fiscal policy, accompanied by prudent monetary policy in the context of a flexible exchange rate system. This policy mix has been instrumental in keeping inflation under control, while permitting a substantial increase in international reserves. Financial policies have been accompanied by structural reforms that have stimulated private investment, including foreign direct investment. The combination of restored confidence and credibility, although still fragile, and new investment opportunities stemming from the reforms, have resulted in record high growth in the past three years. In this context, we urge the authorities to sustain the momentum for market-oriented structural reforms and to continue with a reinvigorated effort of fiscal consolidation. In this regard, we share the staff's view that the slowdown in economic activity during 1996 was not only due to temporary demand and supply factors, but also a consequence of the partial nature of the reforms. The authorities' reaction aimed at boosting investors' confidence through tax cuts and some easing of the monetary stance seems to be having the expected effects as recent surveys suggest a rebound in business confidence. The authorities' policy for the remainder of 1997/98, however, should be carefully balanced. In our view they should avoid further tax reduction and, on the contrary, they should be ready to tighten financial policies if inflationary pressures emerge. Missing the deficit target or further fiscal easing could provide the wrong signal to investors about the authorities' commitment to fiscal consolidation and reform. While we recognize the limitations that a coalition government has in choosing policy instruments and objectives, we believe that restoring full credibility in the government is vital to consolidate gains in growth and inflation.

The fact that India has been growing at rates of over 6 percent per year and has been maintaining domestic savings rates that hovered around 25 percent of GDP despite the large consolidated public sector deficit of around 10 percent of GDP, shows the great potential of the private sector to be the engine of growth. In fact, the record high growth rates since 1993 have been achieved in spite of the substantial crowding out by the public sector. That means that if fiscal balance is achieved and substantial public saving is generated, India could ensure savings rates similar to those attained in the successful East Asian countries and, with a moderate current account deficit, sustain growth rate in the neighborhood of 8 percent per year. Sustained growth rates of this magnitude are necessary to create employment and permanently reduce poverty. In my view, the success in this endeavor depends, first and foremost, on the ability of the authorities to secure a stable macroeconomic environment through fiscal consolidation and on the pace of structural reform. The paper on saving and growth shows that the initial fiscal effort is crucial in determining the virtuous circle of growth and savings. Here, I wish to note only that this has been the experience of my own country, Chile, since the mid-1980s. Going back to India, the staff notes that the level of private saving is already comparable to those in the successful East Asian countries, but that fiscal consolidation still falls well short of what has been achieved by those countries. As a result, public saving in India is still far below the East Asian cases. Thus, I share the staff's view that to set the base for sustained growth further fiscal effort is necessary, particularly on the revenue side, through the widening of the tax base and the reduction of tax distortions. These efforts might prove futile, however, if the significant fiscal imbalances at the state level are not addressed promptly. In that regard, I agree with the staff that by increasing the states' responsibility for raising their own financing, it will expose them to greater financial market discipline, and as long as the central government controls the overall borrowing limit, it will provide enhanced incentive for fiscal discipline in the states.

The fiscal effort should be accompanied by the steadfast implementation of deep-rooted and wide-ranging structural reforms. In particular, priority should be given to privatization and to the continued liberalization of trade to increase competition that fosters efficiency gains and export competitiveness. With regard to the liberalization of the capital account, we agree that it should be carefully phased in tandem with fiscal consolidation and other market-oriented reforms, particularly an enhanced supervisory capacity and strengthened prudential regulations that foster macroeconomic and financial stability. Further capital mobility without fiscal consolidation entails the danger of increased volatility and more pronounced business cycles. More importantly, it has been the experience of a number of countries that capital account liberalization without the proper regulatory and supervisory framework in the financial sector leads to an initial boom in expenditure and asset prices and foreign exchange appreciation which has been normally followed by a sharp recession and financial and exchange rate crises. This does not mean, however, that capital account liberalization should be unduly delayed. Quite on the contrary, this calls for an early and steadfast implementation of a bold reform program in both the fiscal and financial areas. Anyhow, sequence matters.

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

Mrs. Guti made the following statement:

We agree with other Directors that India's economic performance is commendable. This is due in no small measure to the steadfastness of the authorities in carrying out wide-ranging reforms, and their good sense of pragmatism. In a large and diverse country such as India. What has emerged is an economic environment characterized by adjustment with growth and indeed, the growth rates have been impressive, especially over the last four years. Meanwhile, the liberalization policies of the government have improved investors' confidence.

There is still much work to be done, something that the authorities are aware of, as Mr. Sivaraman has noted in his statement that India's performance still has room for improvement. In this connection, we agree with others it is important to press ahead with the process of fiscal consolidation, requiring efforts to both increase revenue and contain expenditure. Continued progress toward poverty alleviation will depend to a large extent on the government's ability to improve the fiscal situation, which will enable it to make the required outlays for such areas as education and health..

As already indicated by other Directors, the authorities also have to deepen structural reforms with a view to enhancing economic efficiency. The staff report draws attention to a number of concerns in this regard, including the need for greater labor market flexibility, a stronger financial sector, and a more improved climate for foreign investment. Efforts to improve the performance of public corporations and to privatize where necessary are also important.

To conclude, I would say that the policies of the authorities are on the right path, and the prospects are encouraging. To combat poverty effectively, the authorities have no choice but to persevere with an economic strategy that focuses on maintaining a high rate of growth, with low inflation. I wish them well in their endeavors.

Mr. Kwon made the following statement:

People usually say that economic reform can be best carried out in an environment of buoyant growth so that adjustment costs are minimized. However, the reality is that many countries undertake painful reform at the bottom of their economic cycle, as a crisis is often needed to precipitate change. India is one such example. The country's remarkably rapid rebound following the 1991 economic crisis suggests that continued implementation of the reform agenda in a period of more favorable economic conditions is likely to have an even greater effect on India's future performance.

Without renewed vigor in the reform process, however, the gains made to date may no longer be sufficient to sustain the high levels of growth that India has achieved recently. I would therefore urge India to be ambitious in the scope and pace of its reform program. I agree with the staff and other Directors that the cornerstone of the reform effort should be strong fiscal consolidation. Such an approach would require action on a number of fronts, including reducing the size of the public sector, broadening the tax base, and changing the incentives for state governments to control expenditures.

Numerous other reforms aimed at further liberalizing trade flows, reducing the complex web of distortions in the economy, and promoting economic efficiency remain to be effected. Implemented together, these reforms would have a mutually reinforcing impact and ensure that adjustment in one sector is not hindered by rigidities in another.

The authorities' desire to rapidly implement capital account liberalization is commendable. We have seen international markets reward sound policies and punish poor ones. Capital account liberalization will undoubtedly generate an imperative for further economic reform. In this respect, I hope the authorities are able to strike an appropriate balance between ensuring that capital account liberalization does not move so rapidly as to undermine the economy, while at the same time ensuring that a disciplined reform timetable is maintained.

With respect to the remaining current account restrictions, I am guided by the staff's assessment in paragraph 53 of the staff report, which indicates that the remaining restrictions are no longer required. I would like to know whether the authorities have any timetable to remove such restrictions and to hear the staff's appraisal of the timetable.

Mrs. Brizuela made the following statement:

Let me join previous speakers in commending the staff for the excellent papers on the occasion of the 1997 Article IV consultation for India. They provide a detailed and comprehensive analysis of the developments in India's economy. As it was pointed out in Mr. Sivaraman's statement, and recognized by other Directors, this country has made impressive progress in its economic performance and structural reform process.

So, I would like to compliment the authorities for the achievements attained during the last years and their firm commitment to the reform program. They have been faced not only with challenges in transforming its economy, but also with the stabilization and the achievement of a sustainable path of growth.

From the staff report and Mr. Sivaraman's statement, we can understand that significant steps have been undertaken in the context of macroeconomic policies. With output growth in 1996/1997 at 6.8 percent, the Eight Plan is expected to end with an overall annual growth of 6.5 percent. Inflation has remained on a moderate trend, declining to 5.9 percent in mid-June. The international reserve position has risen to 6 months of imports level. The rupee has continued to be stable against the US dollar. The gross domestic savings rate rose for the third successive year in 95/96, reaching 25.5 percent of GDP.

Notwithstanding all these very positive results, it is necessary to acknowledge that significant tasks and challenges are still ahead. There should be no room for complacency.

On the fiscal side, the most important task is to reduce significantly the still large fiscal deficit. Even though we recognize the authorities' progress in the public sector deficit reduction, it is still a modest reduction. As it has been pointed out in the staff papers, and by others directors, the fiscal policy needs to be more restrictive. I concur with the staff that efforts should be made to accomplish this target. On this respect, the government should, first, reduce or eliminate the subsidies on fertilizers and food, but, since agriculture remains as one of the most important activities in India, and it is mainly supported by subsidies, authorities should implement urgent and needed reforms in this sector, while subsidies' reform is implemented; second, the authorities should increase their income through a well "tailored" tax system and through the replacement of the administered price mechanism to a market system in the oil sector; and third, they should make further cuts in expenditure. In this regard, I would like to express our strong concern about the reduction in investment expenditures, mainly on education, health and infrastructure. We encourage the authorities to pay special attention on this matter, since these measures do not contribute to alleviate poverty.

On the monetary side, I share Mrs. Gotz-Kozierkiewicz's appraisal about the liquidity. I agree with her that liquidity does not necessarily mean a rapid credit growth; on the contrary, banks have favored the purchase of government securities instead of granting loans to the private sector.

On the structural side, we commend the authorities for the significant progress achieved in the implementation of the structural adjustment program, but there are a lot of goals ahead: capital account, trade system, financial and oil sector liberalization, privatization, tax system and labor market reforms, among the most urgent.

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

Ms. Srejber made the following statement:

I will submit my full statement for the record and just say that I would like to commend the staff for very easily read, comprehensive papers. I join the staff and other speakers in their policy recommendations concerning the need for much more ambitious fiscal consolidation in order to allow for a rebalancing of the policy mix to ease the burden on monetary policy, to stop crowding out, and to facilitate a further decrease in inflation and interest rates.

Other Directors have extensively commented on the need for structural reform. I think I would like to say that, in general, in India there is a significantly too large public intervention in the economy. How the public mixes into every aspect of the economy takes very many forms—rules, regulations, red tape, publicly owned enterprises, putting "caps" on the development of small-scale sector, quantitative trade restrictions, and trade tariffs. The slow-down in industrial output and export growth strongly argues for urgent measures on the supply side. The very slow progress on trade liberalization is troubling. I think we have the textbook list of everything you can do to mix in the market economy. I think one has to believe in the market economy in order to make it work smoothly. I am still not convinced that the Indian government does.

On trade liberalization, I would like to emphasize that this is really a key to growth. I would like to remind Mr. Sivaraman and his authorities about the World Bank study that different chairs have quoted many times here in the Board. If we want to compare high-growth countries, the only common thread is actually free trade. India's extensive quantitative restrictions, tariffs, and everything else one can imagine on the trade side does not really help to promote growth. The experience the government has had in the discussions with the WTO, I think, is hopefully underlining the need for liberalization. But also I would like to remind the authorities that restrictions on trade are not beneficial for consumers in general. They only help lobby groups. I think that poverty alleviation should be a high priority in Indian reforms.

When I read all the very interesting papers for this meeting, what struck me and what was really puzzling was actually that India is growing as fast as it is. As the staff says, economic performance has surpassed expectations. Since India is growing at such a fast pace despite the partial reforms, despite all regulations and distortions, which is a textbook example of what hampers growth significantly, this shows the positive part for India, and my message is that, if India were to embark on speedy macroeconomic stabilization, comprehensive structural reform, true liberalization and deregulation, would not India grow from being a small Bengalese tiger kitten to roar together with the other large Asian tigers?

The staff representative from the Asia and Pacific Department remarked that the remaining current account restrictions—which the staff estimated covered roughly one-third of manufacturing value-added, mainly in the consumer goods area—were imposing a major burden on efficiency and hindered proper price signals in the economy. A large portion of the consumer goods sector was still essentially protected by quantitative restrictions.

The WTO discussions had, unfortunately, not resulted in an agreement to eliminate India's trade restrictions, the staff representative continued. However, the clear announcement by the Indian authorities that they intended to eliminate quantitative restrictions on imports was a significant development. The authorities' envisioned seven-year timetable was much longer than the staff would have recommended, but the desired result was no longer being disputed. The staff saw no balance of payments–related reason for not phasing out the quantitative restrictions quickly; indeed, on efficiency grounds, much stood to be gained from proceeding quickly. Eliminating quantitative restrictions in conjunction with capital account liberalization of outflows and fiscal consolidation also constituted the main measures the staff had recommended to avoid excessive upward pressure on the real exchange rate.

Mr. Sivaraman thanked Directors for having shown so much interest in India's progress and remarked that, although India's scientific and technological development compared favorably with that of any of the industrialized countries, India's complex democracy had hindered the achievement of satisfactorily high levels of economic growth. No single party government had ruled at the center or in any of the 26 states of India for more than a decade. With each political party having its own economic reform agenda, reaching agreement on a given set of measures was difficult. Nevertheless, the current government—a coalition of 13 parties including both extreme left and extreme right of center parties—had managed to carry forward many reform proposals left by the previous government. The trade-off had been between more rapid implementation and the achievement of a consensual approach without conflict.

Most reforms could not be implemented by executive orders, Mr. Sivaraman noted. Changes in laws were often required, which was time consuming in India's parliamentary system of democracy. Indeed, delays in passing laws may have contributed to lower than hoped for foreign direct investment in the infrastructure sector. Enactment and implementation of new laws was gaining momentum, however, including at the state level, where state governments were beginning to realize that large fiscal deficits and chronic financing difficulties were unsustainable.

The fiscal deficit of the central government—which had registered 8.3 percent of GDP in 1991—was expected to decline to 4.5 percent in 1997, and to 3.0 percent thereafter, Mr. Sivaraman continued. The primary deficit of the central government had been reduced substantially, and a surplus might be achieved in 1997 if all went well. The fiscal deficit of the state governments had remained steady at 3 percent for some time, largely because state government borrowing was controlled by the central government.

Providing greater autonomy in market borrowing to the states, as the staff and some Directors had suggested, would be neither easy nor wise at the current juncture, Mr. Sivaraman considered. States in which India's financial centers were located would be able to corner the bulk of available funds, to the detriment of less-developed states. All states, including less-developed ones, were already paying market-related interest rates, although the reserve bank had to persuade banks from time to time to contribute to unpaid loans. State governments seemed to be falling in step with the reforms being undertaken by the central government, however, with at least half a dozen states having announced plans to reorganize their finances through public sector reform. Some states had started selling and/or closing down public enterprises.

State ownership of the economy had been a significant contributor to the fiscal deficit, Mr. Sivaraman continued. As of March 31, 1997, total assets of the public sector units owned by the central government had amounted to Rs 2,600 billion on a historical cost basis, and probably amounted to several hundred billion rupees if valued at market rates. The privatization and closure process would take time. The disinvestment commission had submitted 15 reports to the government, and decisions had been taken on three of those reports. A group of secretaries was currently considering the modality of disinvesting in those undertakings. As of the previous day, the stock market index had exceeded its peak point of two years earlier, which suggested that conditions were favorable for disinvestment.

The overall profitability of public enterprises had more than doubled in the past two years—from Rs 35 billion to Rs 77 billion—and the number of loss-making public enterprises had been declining, Mr. Sivaraman noted. On a related subject, the Prime Minister had suggested in recent statements that a decision would be taken in the coming week or so to free petroleum prices, at least partially, from administrative controls.

The reserve bank enjoyed considerable autonomy in setting monetary policy; that autonomy would be further enhanced by the elimination of the issuance of ad hoc treasury bills, Mr. Sivaraman remarked. The new limit on central government borrowing was, indeed, a change in policy—rather than a renamed version of the old ad hoc financing mechanism—because the central government would not be able to borrow beyond a particular limit. After a certain period, the Reserve Bank of India would need to stop payment on checks of the central government, as was already the practice with the state governments.

The loosening of monetary policy—which had stemmed from unrest among industrialists who had felt that monetary policy had been tightened excessively the previous year—had not resulted in any major macroeconomic imbalance, Mr. Sivaraman continued. Inflation was still under control, with the latest price report recording inflation in the range of 6–6.3 percent. Recent data suggested that the yield curve had started to flatten out.

The government and the Reserve Bank of India were evaluating how best to implement the report of the Committee on Capital Account Convertibility, Mr. Sivaraman noted. One or two measures to allow foreign direct investment by Indian entrepreneurs had already been introduced, including investments in foreign companies, joint ventures, or other enterprises of up to 50 percent of the resources raised through global depository receipts.

The authorities were following a flexible exchange rate policy but were mindful of competitiveness concerns should the rupee appreciate considerably, Mr. Sivaraman remarked. Exports had increased by 8 or 9 percent as of May 1997. Although it was still too early to predict whether that trend would continue, business confidence had been restored, which could lead to a turnaround in exports for the year as a whole.

Subsidies in India, particularly by the state governments in the areas of power, irrigation, and transportation, were admittedly high—although perhaps not quite as high as the methodology used in the white paper on subsidies suggested, Mr. Sivaraman continued. Some states had begun to revise tariff rates to move toward cost recovery. Many of the electricity boards—perhaps influenced by World Bank and ADB loan conditionalities—had started considering tariff revisions. Subsidies for higher education—which were indirectly passed on to the United States with the migration to that country of India's newly trained doctors, engineers, and scientists—were beginning to be reduced, particularly in the institutes of technology. The elimination of subsidies in other areas was likely to take quite a while.

As Mr. Kiekens had noted, agricultural subsidies were a sensitive issue and would take time to eliminate, Mr. Sivaraman remarked. The industrialized countries currently paid roughly $180 billion on agricultural subsidies. A 1996 paper by a World Bank economist had noted that fertilizer subsidies in India were particularly complex. India's fertilizer industry was the second largest in the world and affected millions of farmers. A well-thought-out plan, including alternatives to protect India's hard-won agricultural strength, would need to be in place before withdrawing the fertilizer subsidy. The expert committee looking into that issue had asked for an extension of time but was likely to submit its report in another three or four months.

Few restrictions on interest rates remained, with the exception of loans up to Rs 20,000—a small segment of total lending—and of deposits of up to one year, Mr. Sivaraman observed. In the past year and a half, a number of capital market regulations had been brought in line with international standards and made transparent, with the help of input from private sector experts.

Of the 27 public sector banks, 24 were profitable, and increasingly so, Mr. Sivaraman noted. Although no clearly defined exit policy was in place, weak banks were being downsized. Privatizing the public sector banks—which controlled almost 80 percent of the deposit base—would take time. The authorities had begun to sell off shares of four banks; somewhere between 22 and 24 percent of those shares had been purchased thus far. In the meantime, 37 new private banks had been set up, 40 applications for small banks were pending, and 14 applications for large banks were also being evaluated. As of May 21, 1997, 40 foreign banks were operating in India. He himself was not aware of any major restrictions on the entry of foreign banks that adhered to the norms.

The need for labor market reform was acutely felt throughout Indian society, Mr. Sivaraman remarked. Strong trade unions had hindered the authorities' reform efforts, but the process of dialogue had begun. The bipartite committee established by the government the previous year to examine changes in the Industrial Disputes Act had not been able to agree on most of the issues. Some industries had worked out their own exit policies in cooperation with their employees. Progress at the government level was likely to be drawn out.

Defense expenditures as a proportion of GDP had declined by roughly 30 percent over the past decade, from 3.6 percent in 1986/87 to 2.4 percent in 1997/98, Mr. Sivaraman noted. He did not consider the current level of defense expenditures to be excessive.

Social sector spending—at both the central government and the state levels—had been stepped up in the past three or four years, Mr. Sivaraman continued. State governments had authority over most of the social sectors. Expenditure on social services, as a proportion of expenditures as a whole, had increased from 35 percent in 1995/1996 to 37 percent in 1996/97. Capital expenditure had also increased from roughly 7 percent to 10 percent of total expenditures during the same period. Most of the state governments had incorporated total literacy programs into their budgets, and they hoped to achieve literacy objectives within the next three to four years.

The central government had sharply reduced recruitment of new personnel in recent years, even among the higher ranks of civil servants, Mr. Sivaraman remarked. He personally had reduced the number of new recruits from almost 100 per year to 25 per year. Over the past three or four years, more than 100,000 vacancies had not been filled. The Pay Commission had recommended a reduction in the civil service of almost 40 percent over the next three or four years.

The phasing of trade liberalization was being debated in the WTO, with most of the disagreements focused on agricultural issues, Mr. Sivaraman remarked. The WTO representatives of member countries would be able to provide further details.

Much scope existed for widening the tax base and improving tax efficiency, Mr. Sivaraman agreed. The tax/GDP ratio, at 16.4 percent, was low and could be improved upon. A recent report on the modernization of the income tax law called for the elimination of a large number of exemptions. Some states were beginning to introduce a value-added tax, but, for the most part, were moving slowly owing to concerns about revenue losses. A proper value-added tax administered by both the central government and the states would require a constitutional amendment. States were therefore exercising their rights to tax commodities, and the central government had converted its excise tax into a form of modified value-added tax. The existing sales tax legislation incorporated all the elements of a value-added tax.

Infrastructural bottlenecks were becoming more problematic, but slack in the system was likely to reduce pressure on infrastructural facilities for a few years more, Mr. Sivaraman considered. Substantial progress had been made in enhancing the role of private enterprises in the import sector, road construction, and port development.

India's budget was transparent and reflected all state and central government transactions—with the exception of public sector enterprises, which had their own budgets—Mr. Sivaraman remarked. The budget was fully computerized and properly classified all government activities. An independent auditor general reported his audit findings directly to the parliament.

Revenue sharing provisions in the constitution were reviewed every five years by an independent commission, Mr. Sivaraman noted. A recommendation that the central government share all its tax revenues with the states up to a certain percentage was currently being debated. The central government had accepted the proposal; the states also appeared to be close to accepting it.

Other federal transfers to the states were handled by the Planning Commission, Mr. Sivaraman added. Transfers were sometimes made to provide relief for unusual difficulties experienced by individual states, or to develop particularly poor regions. How those transfers were made, especially in the former case, had been the subject of some criticism. While it was unlikely that such ad hoc transfers would be eliminated, the central government and the states were considering ways to improve the system.

The exchange restrictions referred to in the staff report related in part to bilateral agreements with Russia and the former Czechoslovakia, Mr. Sivaraman noted. Another restriction concerned the repatriation of loan principal, which the Reserve Bank of India objected to on the grounds that such transactions constituted capital transfers. Interest on loans, however, was freely transferable. The remaining restrictions—an adjustment on foreign television media and dividend balancing for consumer industries—were being reviewed to determine whether they could be removed quickly.

As Mr. Mirakhor had mentioned, sustainability of reforms required that the pace of implementation be tailored to political realities, Mr. Sivaraman concluded. Particularly in a large democracy such as India's, trade-offs would have to be made between deep structural reforms and political consensus.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that India's overall economic performance had remained broadly favorable, despite a recent slowdown in industrial production and exports. The continuation of strong economic growth without major signs of an acceleration in inflation and with a strengthened external position was welcome evidence of the continuing robust supply response to the structural reforms initiated in the early 1990s. Directors commended the authorities for pursuing policies that had set the Indian economy on a new course of modernization to meet the challenges of globalization, and they encouraged the authorities to sustain the renewed momentum of reform. Directors reiterated that, to sustain high growth, reduce poverty, and realize India's economic potential, it would be necessary to make decisive progress toward fiscal consolidation and push forward with the still long remaining agenda for structural reforms.

Regarding short-term macroeconomic management, Directors considered that vigilance was required to avoid a buildup in demand pressures. They generally shared the staff's view that the recent slowdown in industrial production and exports was, to a considerable extent, a consequence of the partial nature of the reforms, which had contributed to infrastructure bottlenecks and continuing constraints in the financial sector. In view of the uncertainties associated with the short-term outlook, Directors stressed the need to monitor developments carefully and to tighten the policy stance promptly should inflationary pressures intensify. Some Directors cautioned against stimulative macroeconomic policies in the face of the moderate growth slowdown.

Directors noted that the large public sector deficit was a drag on economic performance. The fiscal deficit not only reduced national saving and crowded out investment, but also placed an excessive burden on monetary policy in maintaining macroeconomic stability. Directors expressed concern that even the modest deficit reduction targeted in the 1997/98 central government budget might not be achieved. Since there was a significant risk that revenues would not respond to recent bold tax cuts as buoyantly as anticipated by the authorities, Directors stressed the need to be ready to implement contingency measures. They also underlined the need to accelerate the disinvestment program, the urgency of implementing a substantial increase in petroleum prices, and the need to phase out fertilizer subsidies.

Beyond the present fiscal year, Directors welcomed the authorities' target of lowering the central government deficit to 3 percent of GDP by the turn of the century, but emphasized that there was a need for more ambitious efforts to reduce the overall public sector deficit decisively from its present level of about 9 percent of GDP. At the central government level, the recent tax rate cuts needed to be complemented with measures to expand the base, reduce tax exemptions, and improve tax administration. It would also be important to reduce civil service employment and cut and better target subsidies. Many Directors also called for improvements in the composition of expenditure to reorient spending from unproductive spending, such as subsidies, toward infrastructure and social spending on health and education; while a point was made that the authorities had reduced defense spending as a proportion of GDP, a few speakers referred to the need to reorient such spending toward infrastructure and the social sector. Directors welcomed the authorities' approach of promoting public discussion on the issue of subsidies through the issuance of a "white paper." More vigorous efforts were needed to improve public enterprise performance including full privatization of many of those companies. Directors stressed that adjustment was also needed at the state level to lower deficits and to improve the composition of state spending. They emphasized the importance of following through with recent state-level initiatives, and they suggested that the center could encourage that process by enhancing the incentives for adjustment at the state level.

Directors observed that while surging private capital inflows signaled growing confidence in the Indian economy, such inflows could lead to an unintended loosening of monetary policy unless the exchange rate were managed flexibly. Directors welcomed indications that the authorities were prepared to adopt a more flexible approach to exchange rate management. They emphasized that the most effective means for mitigating upward pressures on the real exchange rate in the face of rising capital flows was through a faster pace of trade liberalization, accelerated fiscal consolidation, and the easing of restrictions on capital outflows.

Directors called for a cautious stance on monetary policy. Noting the present high level of liquidity in the banking system, they cautioned particularly against the possibility of rapid rates of credit creation. They stressed that the authorities should not resist increases in interest rates particularly at the short end in the event of a pickup in credit demand. Directors welcomed the ending of the system of automatic Reserve Bank of India (RBI) financing of the government budget deficit, but stressed that this would have to be accompanied by further measures to enhance the RBI's operational independence.

Discussing the agenda for reforms, Directors emphasized the importance of further trade liberalization including further tariff cuts and a more rapid elimination of remaining quantitative restrictions on consumer goods and a more comprehensive easing of small-scale sector reservations. A few Directors expressed disappointment that agreement was not reached with the WTO Committee on Balance of Payments Restrictions on the phasing out of quantitative restrictions. Directors called for an acceleration of financial sector reforms, supported by further efforts to strengthen banking prudential norms and supervision. Directors stressed that the best prospects for achieving a fundamental improvement in the banks' operating efficiency would result from an increase in the private sector's role in bank management. Some Directors also called for an easing of the restrictions on the operation of foreign banks in India. Another key priority for structural reform should be to establish more effective exit policies in order to facilitate the redeployment of resources across sectors. Some Directors pointed to the need for labor market reforms to increase the flexibility of those markets.

Directors recognized the considerable potential efficiency benefits India would gain from capital account liberalization and welcomed the forward-looking proposals put forward by the Committee on Capital Account Convertibility. They considered that it was important to ensure that liberalization was phased carefully and dovetailed with the necessary domestic adjustments. In particular, Directors stressed the need for fiscal consolidation and trade reforms to reduce the risks that resources could be misallocated internally. They also emphasized the need for the further strengthening of the domestic banking system to prepare it for a more competitive financial environment. Directors noted that there was considerable scope to move forward at an early stage to liberalize further equity inflows and foreign direct investment. The Committee on Capital Account Convertibility's proposal on the establishment of transparent guidelines for foreign direct and portfolio investment was welcomed.

Directors urged that the remaining exchange restrictions subject to approval under Article VIII be eliminated as quickly as possible. They welcomed the authorities' decision to subscribe to the Special Data Dissemination Standard and underlined the need to improve India's economic statistics to provide more timely and reliable guidance for macroeconomic policy decisions.

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

The Executive Board took the following decision:

1. The Fund takes this decision relating to India's exchange measures subject to Article VIII, Sections 2(a) and 3, in the light of the 1997 Article IV consultation with India conducted under Decision No. 5392-(77/63) adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The exchange restrictions and multiple currency practice described in SM/97/147 are subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund notes the authorities' intention to eliminate the multiple currency practice arising from remaining exchange guarantees under the former Foreign Currency Nonresident Account scheme by August 31, 1997 and extends the approval for its retention until end-August 1997. The Fund urges India to eliminate all other remaining restrictions as soon as possible. (SM/97/147, 6/11/97).

Decision No. 11534-(97/67), adopted
July 2, 1997

5. IRELAND—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Ireland (SM/97/138, 6/4/97). They also had before them a paper on selected issues (SM/97/151, 6/17/97).

Mr. O'Loghlin made the following statement:

My authorities are in general agreement with the assessment of Ireland's economic situation and policies contained in the staff report, and with the thrust of the report's recommendations. They have asked me to convey their appreciation to staff for the perceptive observations provided during the recent Article IV discussions in Dublin, and for the clarity of the conclusions presented in the end-of-mission statement.

As is clear from the staff report, the Irish economy made substantial further progress last year. Indeed, preliminary national accounts published in mid-June both revised GNP growth over 1994 and 1995 upward by a cumulative 1 percent and reported a 6.9 percent expansion in real GNP in 1996, even higher than estimated at the time of the staff visit. Strong investment and personal consumption were the key factors. Although export volumes rose by more than 10 percent the current account of the balance of payments weakened a little, reflecting high capital goods imports in particular. Nonetheless the current account remained in surplus. Latest data (also available only very recently) indicate a surplus of 2¼ percent of GNP compared with (a revised) 3 percent in 1995. External reserves remained comfortable, in consequence. The strong economic growth was reflected in an increase in employment of the order of 4 percent—for a second year in succession, and in a fiscal deficit substantially below the budget-day target. Consumer price inflation decelerated to 1.6 percent, inter alia, reflecting earnings increases in both manufacturing and the broad financial sector somewhat below 3 percent over the past year.

With economic growth running well ahead of initial expectations, taxes and other current revenues also exceeded target by a large margin—more than 1½ percent of GDP. These extra resources were largely devoted to reducing the general government deficit below target, to less than 1 percent of GDP and well within the Maastricht parameter. This low deficit, in combination with rapid growth, resulted in a reduction of more than 8 percentage points of GDP in the burden of public sector indebtedness, bringing the Irish debt/GDP ratio close to the average now obtaining across the European Union.

Looking ahead, as the staff report notes, the 1997 Budget was the first to be explicitly couched in a medium-term fiscal framework. It established deficit goals for 1998 and 1999 of a maximum of 1½ percent of GDP—as staff rightly points out, to shift the public focus to a more ambitious objective than the Maastricht 3 percent deficit requirement. The new government which has taken office following our recent elections has established still-tighter goals, with an eye to the EU Stability and Growth Pact and because we believe that it will better serve the economy in the longer term. Subject to the proviso that current expectations for economic growth over the years ahead are fulfilled, it aims at eliminating Exchequer borrowing over the next two to three years, inter alia, by limiting growth in current expenditures to 4 percent annually in nominal terms.

In this context, some amplification of references in paragraph 12 of the staff report to commitments on tax reductions and welfare spending may be useful. In the absence of annual "concessions" the real value of Irish welfare payments falls, the burden of personal taxes on any given level of (real) income rises, and the fiscal deficit narrows—because welfare payments/tax thresholds are not indexed. These commitments, part of the current three-year pact with the social partners, therefore constitute a much smaller extra charge on the Budget than 3 percent of GDP—and are subject to the overriding requirement that the fiscal position must remain consistent with EMU obligations. Developments thus far in 1997 indicate that this year's Budget will again emerge ahead of target. Indeed, the deficit seems likely to fall to ¾ of 1 percent of GDP, putting us well on the way toward achieving the latest medium-term goal. And the strong investment growth of recent times, together with the new social compact which envisages wage increases averaging less than 3 percent a year over the next three years, bode well for future growth prospects.

It will be obvious that restraint of public sector pay is implicit in the incoming government's budgetary objectives, and thus that any effort by other groups to exploit the significant award made to nursing staff (paragraph 34) will be strongly resisted. High growth tends to induce high wage expectations. The government, therefore, has sought to impress on the public mind, and especially on the public sector, that the larger part of growth in recent years reflects rising employment—and thus was not earned by, and is not attributable to, those already in employment. They are also conscious that, in an economy where trade represents 150 percent of GDP, international competitiveness must be jealously guarded. Cost developments must, at most, be kept in line with those elsewhere, if the ability to confront still-high unemployment is not to suffer as Ireland becomes even more integrated into Europe. Hence, they are keenly aware that developments in public pay must not put at risk the consensus which now exists for moderate increases over the period to 1999.

The objective of monetary and exchange rate policy continues to be to maintain low inflation, consistent with Ireland's aim of participating in monetary union from its inception. While inflation decelerated during 1996, my authorities nonetheless recognize the risk to prices which is inherent in continuing rapid economic growth. They are carefully monitoring developments and, as demonstrated by the recent (preemptive) increase in official interest rates, will not hesitate to tighten the monetary stance should signs emerge of a pick-up in inflation. The more complete unwinding through recent weeks of the appreciation of the effective exchange rate which had taken place since early 1995 has considerably heightened attention to price prospects. However, price indices—as yet at least—do not evidence any pick-up and new downward pressures continue to emerge, most recently in the form of the announcement of imminent arrival into Ireland of yet another overseas retailing chain and a further phase of telecommunications deregulation. Indeed the rate of consumer price increases has continued to decelerate marginally—to 1.5 percent in the year to May 1997.

In considering the degree to which the Irish economy may suffer from problems of a structural nature it may be useful for Directors to have a context for the staffs' remark (paragraph 16) that more jobs have been created in the past 3 years than in the previous 30. While total employment in Ireland over the period 1960–1994 rose by a very meager ⅓ of 1 percent annually, this comprised a decline in numbers employed in agriculture of 3 percent annually and a 1⅓ percent annual increase in the remainder of the economy. An agriculture-based decline in employment has masked a solid performance elsewhere in the economy—albeit one which was insufficient to respond to potential labor force growth.

On specifics, staff is quite right to note Ireland's substantial long-term unemployment as a key issue. This is being addressed as best it can, both through better incentives (as is clear from Chart 3 of the selected issues paper, replacement ratios have been falling in recent years, even if slowly) and by programs of activation (aimed at the long-term unemployed and young people who have left school with few qualifications, and designed to raise skill levels, to instil a work ethic and to enable participants to demonstrate their capacity and willingness to work to potential employers). The staff advice to monitor the outcomes of such programs is, however, apt and will be borne in mind.

The staff also questioned whether increases in welfare payments included in this year's Budget are consistent with strengthening incentives to work. From the standpoint of the long-term unemployed, the budget raised the "Family Income Supplement" (a scheme which supplements the income of parents in low-paid employment) in an amount which, combined with nominal pay increases under the new social compact and reductions in personal taxes, outweighs welfare increases. More critically, my authorities view the welfare increases as contributing to acceptance of the new social compact, thereby securing growth potential (by affirming low increases in wage costs and continued industrial peace into the medium term) and thus to securing a basis for employment expansion. This, in turn, will heighten the job prospects of the unemployed generally—but, it must be recognized, those with fewer skills will always be at a disadvantage so long as labor supply outruns labor demand.

On corporate taxation, staff suggests that the aim should be to establish a low unified rate for all corporations. The incoming government intends to do precisely this, by progressively reducing the existing higher corporate tax rate.

In line with its commitments both as a member of the EU and as a subscriber to the SDDS, Ireland began to produce monthly consumer price data in January last. The timeliness of certain data, particularly on trade which became less timely when the EU adopted the INTRASTAT system and is not yet in line with SDDS requirements, has been improved through the past year, and steps are in train to enable production of national accounts on a quarterly basis by 1999. I anticipate that Ireland will fully meet the requirements of the SDDS within the envisaged time frame.

Extending his remarks, Mr. O'Loghlin stated that the new government—which had taken office the previous week—had identified a successful transition to European Economic and Monetary Union (EMU) as Ireland's key economic challenge in the period ahead. The objective of participation in EMU from its inception remained unchanged. In that context, the broad socioeconomic program of the new government was subject to the overriding requirement to stay within the terms of the EU Stability and Growth Pact and the Maastricht criteria, with fiscal policy aimed at eliminating exchequer borrowing over the next two to three years.

The approach of recent years of reducing personal taxation and social security charges in order to heighten incentives to work and to reduce employment costs would continue as resources permitted, Mr. O'Loghlin remarked. Existing initiatives aimed at enhancing the job prospects of the longer-term unemployed and of young people who leave school with limited qualifications were to be strengthened. Finally, noting developments abroad and some tendency toward a two-tier society in Ireland, the government was planning to introduce a national hourly minimum wage to ensure against social exclusion and marginalization of the few while the greater number prospered.

Mr. Donecker made the following statement:

> Overall Ireland's economy is in pretty good shape. With strong fiscal and monetary policies, combined with structural reforms strictly implemented and supported by a broad social consensus, Ireland has made impressive progress in recent years. This holds particularly true in reducing fiscal imbalances, inflation, and unemployment, as well as in achieving stronger than initially expected economic growth. This growth is being driven not only by exports, but increasingly also by investments and domestic private consumption. Of course, EU membership has helped quite a bit, but most of Ireland's remarkable economic progress in recent years is the result of good policies and hard work.
>
> However, we concur with staff, that the challenge Ireland is currently facing is to maintain this favorable performance over the medium-term without encountering destabilizing pressures on resources. In the light of the current cyclical position, with some signs of pressures on resources, as evidenced, for example, by the recent sharp increase in housing price and strong labor demand, an additional fiscal tightening, and the maintenance of a prudent monetary policy stance, would appear to be the appropriate response to avoid a possible overheating. In addition, structural reform efforts should be accelerated in order to enhance economic flexibility, particularly in the labor market.
>
> Since I am in almost total agreement with staff's analysis and policy recommendations, I will confine my comments to some remarks on fiscal and monetary policy, and on labor markets for emphasis.
>
> On fiscal policy, the fiscal program (Convergence Program), in our view, appears to be somewhat problematic, since, with increasing deficits in 1997, the program will tend to have a rather procyclical and expansive impact. This risk might also hold true given the past slippages with regard to restraining expenditure growth through announced ceilings. The increase in deficits is also partially, the consequence of the "Program 2000," since, in

order to secure wage moderation, it provides "front-loaded" tax cuts and allows for an increase of social expenditure. In our view, however, tax cuts should be offset by expenditure cuts, and not by increasing deficits.

We also share staff's assessment, that in view of the cyclical position and the increasing constraints on monetary policy, as well as in the light of the Stability and Growth Pact and the expectation of a phased reduction in EU transfers after 1999, because more ambitious fiscal consolidation efforts would be warranted. We too believe that it would be desirable for the Irish authorities to aim at fiscal balance by 1999. In this context, I am pleased to note that, according to Mr. O'Loghlin, the new government has established tighter fiscal goals aiming at fiscal balance over the next two to three years.

A tighter fiscal policy is also conducive to alleviating the strains on monetary policy, and thus to reducing the relatively high real interest rates as well as the still considerable interest rate differentials vis-à-vis Germany.

With regard to monetary policy, I have no doubt that the monetary authorities in Ireland will continue with their prudent approach, given their achievements in the past, and as demonstrated by the recent upward adjustment of interest rates. In this context, I also welcome Mr. O'Loghlin's respective assurance, i.e., that the monetary authorities are fully aware of the inherent price-risks in continuing rapid economic growth and that they "will not hesitate to tighten the monetary stance should signs emerge of a pick-up in inflation."

Finally, on labor markets, Ireland has made considerable progress in tackling the unemployment problem. From 1993 to 1996, for instance, Ireland scored the highest decline in unemployment among the OECD countries (from 16.7 percent to 12 percent). However, despite exceptional job creation (3.8 percent a year), total unemployment, which means predominantly long-term unemployment, is still above the OECD average. This is clearly a matter of concern, and the stubbornly high unemployment remains the central structural problem in Ireland. In this context, we share staff's concerns, that, for instance, due to high marginal tax rates, work incentives for low-skilled workers are insufficient. Work incentives, in particular for the long-term unemployed, should also be strengthened by a tapering off and better targeting of the relatively generous unemployment benefits over time and limiting their duration. I welcome the respective intentions of the new government as indicated by Mr. O'Loghlin.

To conclude we wish Ireland, the new green tiger in our European midst, so to speak, much further success.

Mr. Andersen made the following statement:

I was delighted to see from the first line in the staff appraisal that recent economic performance of Ireland was labeled as spectacular, going a bit further than the word impressive which, I think, is the more normal phrase used for our most successful members. Let me emphasize that I found this characterization to be well deserved. Whether the source is the Fund, the OECD, or others, all seem to agree that the Irish momentum is a "River Dance" of success. The authorities' approach has indeed been a success story with the simultaneous achievement of sound fundamentals, including low inflation and high growth, and with an impressive job creation record during the last few years. While the authorities have carefully choreographed all key moves in the performance, and thus deserve most of the applause, favorable external conditions and exchange rate developments have also helped earn the Irish economy a standing ovation.

Nevertheless, there are some interesting challenges that lie in Ireland's way while the country is preparing for participation in EMU from its inception, as well as in the larger run. Most of the near-term challenges seem connected with the risk of overheating and associated issues with regard to the policy mix. While inflation has indeed remained low, even in the context of stronger than expected growth as demonstrated in Mr. O'Loghlin's useful statement, and despite that we continue, not only in Ireland but in many advanced economies, to be surprised by the strength of the low inflation environment, it appears to me that the risks generally are on the upside, implying that a tightening of the overall policy stance may well be needed to ensure that a soft landing scenario will materialize.

Contributing to the risk of overheating is the fact that fiscal policy has been pro-cyclical and is expansionary this year as well. Reductions in taxes and increased social expenditures may well lead to continued strong growth in private consumption, not least in a situation where there are considerable wealth effects coming from the housing boom, which often induce households to bring down their savings balances. Moreover, a number of traditional indicators, such as capacity utilization and the growth in the credit aggregates, and the fact that forecasters continue to underestimate the strength of the expansion of the Irish economy, further add to the need for being vigilant and prepared to tighten the policy stance. Thus, although the authorities have constrained cost-push inflation from domestic sources with the adoption of the Partnership 2000 agreement, I fear the front-loaded personal tax package, immediately granting almost half of the personal income tax cuts agreed over the duration of the agreement, may overstimulate the economy. On the monetary side I also note that there appears to be a strong negative relationship between changes in the effective exchange rate and inflation. Earlier calculations made by the Bank of Ireland suggested that a 1 percent decrease in the effective exchange rate would result in a 0.44 percent increase in inflation with a lag of three quarters, a sensitivity that may not be without interest in the coming period. Moreover, the high levels of consumer and investor confidence, combined with the very low interest rates, are likely to augur well for continued strong growth.

I note and welcome Mr. O'Loghlin's assurance that his authorities are carefully monitoring developments and are taking the risk seriously as demonstrated by their preemptive increase in official interest rates recently, a decision I welcome. I would, however, argue that, under the present circumstances and with the room for maneuver for monetary policy becoming increasingly limited as EMU approaches, it would be preferable to meet the challenges through an additional tightening of fiscal policies. In this context, I welcome the comments made by Mr. O'Loghlin in his statement that the new government has established tighter fiscal goals.

The effectiveness of Irish monetary policy has clearly been demonstrated by Ireland's success in maintaining low inflation in a sustained period characterized by exceptionally strong and above-trend growth. However, it seems to me that the room for maneuver is becoming very limited. Whatever the scope for further monetary tightening might be in the very short term, transition to the euro area may necessitate that short-term interest rates converge to those applying in the euro area over the coming period. Thus, it cannot be excluded that the authorities could face a scenario in the run-up to EMU where we would see a downward trend in the effective exchange rate being amplified by a downward trend in the short-term interest rate and overall looser monetary conditions. I wonder if the staff could elaborate a little further on how they see the probability of such a scenario and their comments on the appropriate policy response.

On fiscal policy, I agree that Ireland has established an impressive fiscal policy record, not least in a European Union context where Ireland is belonging to an exclusive but rapidly broadened group of countries where the budget deficits are not considered to be excessive. I also welcome the adoption, with the 1997 budget, of a medium-term framework for fiscal consolidation. Having said that, I am of the view that Ireland should aim for more progress in fiscal consolidation during the current strong growth phase and aim for a budget close to balance or surplus over the medium term. Indeed, with such strong growth for many years a budget surplus could have been expected at the present stage. I would also like to question the appropriateness of the present fiscal policy stance of leaning with the wind instead against it, as is the case this year with the significant front-loaded tax reductions and increases in expenditures. In addition, long-term demographic trends will add significant strains on the Irish economy as is expected for other advanced economies to which comes the potential challenges from decreased allocations from the EU structural funds after 1999. All in all, a more ambitious reduction in the deficit would appear appropriate both to the short-term position and to the medium- and long-term prospects of the Irish economy. I agree that a further tightening of fiscal policy should concentrate on the expenditure side, but there may also be room for increasing taxation of enterprises leading to a reduction in the element of tax competition.

On structural policies I have little to add to the staff. The recent job creation and apparent labor market flexibility fares very well in comparison to other European economies, but Ireland's substantial long-term unemployment, in particular, deserves continued close attention.

Let me conclude by stressing that, while I have highlighted some of the still important policy challenges, I take significant comfort from the fact that Ireland's track record in taking appropriate measures when needed is quite impressive, and I would not want in any way to diminish the achievements to date, which indeed are quite spectacular.

Mr. Goffinet made the following statement:

The strength of the Irish economy was reflected once more in 1996 by remarkably strong demand-led growth. Sound outward-looking policies and strong financial discipline have contributed to real GNP growth of 6.5 percent and a large increase in employment. These developments sharply reduced the unemployment rate, which still remains high at 12 percent. Fiscal deficit has been held to less than 3 percent of GDP, and the debt-to-GDP ratio has fallen from 82 percent to an estimated 73 percent. Inflation remains low, thanks partly to the firm exchange rate stance and continued wage moderation. The current account remains in surplus. Ireland's impressive economic performance in 1996 is no isolated achievement, but a continuation of the tremendous progress made during the past decade.

Ireland's overall performance was achieved in an environment of sound economic management, and was fueled largely by foreign direct investment, a growing skilled work force, and a social consensus on wage restraint. Irish growth in 1996 was domestically driven by growing household consumption backed by strong income growth and the continued expansion of employment. The support received from exports was less steady.

In 1996, strong labor demand, especially for skilled workers, encouraged inward migration and a higher female participation rate. The result was strong employment growth of 3.9 percent. But because many of the new jobs went to new entrants into the workforce, the 1996 rise in employment was not matched by a corresponding decline in unemployment. The unemployment rate, which was 16.7 percent in 1993, was still 12 percent in 1996, and Ireland's long-term unemployment rate is still above the OECD average. Revising tax provisions for workers and reducing the generous benefits paid to nonworkers in order to increase the financial rewards of working, should increase the incentives for low skilled, poorly educated workers to find employment, thereby making the labor market more flexible. In addition, we encourage the authorities' pursuit of special employment and training programs, which should be well targeted and cost effective.

Despite the continued favorable performance, with output growth approaching its potential, there are no immediate signs of inflationary pressure, due partly to a lowering of growth expectations, to competitive pressures related to foreign direct investment in the nontraded sector, and to the general openness of the Irish economy. The Central Bank of Ireland's annual report also underlines the inflation benefits of 1996's firm exchange rate stance. Inflation remained low despite a booming economy, rising housing prices, and strong labor demand. However, the central bank does foresee "risks and latent pressures that point to a rise in inflation in the second half of the year."

Ireland's monetary and exchange rate policies, focused on price stability, caused the Irish pound to appreciate toward an upper level of the

ERM band, well above the central rate. Because it will prevent an undesirable increase in demand and activity, the authorities would like to enter the EMU with a market-determined rate rather than the lower central rate that could trigger the emergence of inflationary pressures. If the EU decides to use the central rates for EMU entry, how will the authorities adjust their policy stance in order to prevent a surge in inflation and the risk of overheating the economy? They might have to seek a realignment in the ERM before the decision is taken on EMU entry rates.

Irish fiscal policy, which has achieved low deficits and a reduction of debt, still faces several challenges. The prospect of lower future growth, uncertainty concerning EU transfers after 1999 and the disappearance of monetary policy autonomy on entry into EMU, calls for the authorities to aim at achieving as solid a macroeconomic foundation as possible, aiming toward a balanced budget and a reduction in borrowing.

The staff paper underlines that only very timid progress has been made toward the privatization of public companies. We think that more ambitious measures are called for. Indeed, the advantages of privatization extend beyond the immediate fiscal benefits by creating conditions conducive to higher growth.

Finally, we welcome Ireland's improvement of its statistical data system. With these remarks, we wish the authorities all the best in their future endeavors. We believe they are well positioned to be among the first countries participating in the European Monetary Union.

Mr. Disanayaka made the following statement:

We congratulate the Irish authorities for maintaining an excellent record of economic performance over the past decade. During this period the country has consistently maintained a sound macroeconomic position by adopting a highly outward looking policy and prudent fiscal and monetary policies. The authorities' prolonged commitment to such a sound macro stance has enabled Ireland to achieve the fastest average growth rate within the EMU, fiscal deficit below Maastricht level of 3 percent for eight years, a rapidly declining debt to GDP ratio, an inflation rate below the EMU average and a decline of unemployment ratio from about 16 percent in 1992 to projected 11.6 percent in 1997. The medium-term prospects for the Irish economy look positive provided the present momentum is continued and the external situation remains favorable. Ireland therefore looks a sure bet for first round entry into the EMU. However, as the staff report points out, the main challenge is how to maintain this excellent performance up to and especially within EMU. This is a tougher challenge for which the Irish economy has to make further preparations, not just trying to qualify for entry.

As we concur with the excellent assessment made by the staff and their recommendations, we have only a very few points to make, that too mainly for the sake of emphasis.

In our short intervention last year in the course of Article IV discussion on Ireland, we voiced our concern over possible risk of overheating in the economy. We wish to reiterate our concerns this year too in view of the continued rapid growth of the economy and the pressures that have begun to appear from several quarters, like the tight property and labor markets, and rapid credit growth. Authorities have so far avoided the risk of overheating by skillfully managing the economy through enhancing the efficiency of resource use, modernization of the manufacturing sector and wage moderation. However, the recent abolition of the residential property tax and the conclusion of a wage settlement for nurses substantially above the general level of wage settlement for other sectors threaten to complicate this prudent policy stance. A close scrutiny, therefore, of developments in these sectors is vital. In this connection, the comments made by Mr. O'Loghlin in his helpful statement as regards the authorities' strong commitment to keep these pressures under control are reassuring.

With regard to fiscal policy, we welcome the formulation of the 1997 budget in a medium-term framework. The framework, together with the commitments made under P 2000, endeavors to achieve a rather ambitious fiscal position in the medium term, well below Maastricht level. The staff, in Appendix IV, has suggested an even more ambitious deficit target for the medium term in view of the possible overshooting of Maastricht ceiling in coming years, if a slowdown in growth were to occur. We are however encouraged by the comments made by Mr. O'Loghlin in paragraph 5 of his statement that the 1997 deficit at the present rate of developments could fall to half of the target envisaged. Nevertheless, the situation has to be watched carefully in view of the stringent stipulation for deficits in the Stability and Growth Pact of EMU.

The monetary and exchange rate policies followed by the Irish authorities in the past few years have been consistent with their broad objective of low inflation and strong growth. In this regard, we welcome the recent preemptive tightening of monetary policy, to counteract any downward pressures on the Irish punt on expectation of possible decline in interest rates after the country's entry into EMU. We hope that the authorities would continue with such flexible policies to cope up not only with such developments based on speculation, but also with the real pressures that are threatening to complicate inflation management.

We welcome the authorities' efforts to narrow the tax gap between the standard and the 10 percent corporate tax rates. The ultimate objective should be to establish a low unified rate for all corporations.

On the labor market issues, we applaud the authorities for their commendable performance in maintaining wage moderation through centralized multi-year wage agreements negotiated with social partners. In particular, we welcome the new centralized wage pact—P 2000 concluded this year. We have already expressed our concerns over the deviations that have occurred in this sound policy and hope that the authorities would try to avoid them in future. In this respect, we would like to see early implementation of the recommendations of a Report made last year by an Expert Group on the integration of the Tax and Social Welfare systems.

The Irish authorities have made excellent progress in reducing unemployment through appropriate incentives for work and of course through rapid expansion of their economy. However, they have still a long distance to go in this terrain as long-term unemployment has remained sticky. While welcoming the various steps taken by the authorities to tackle this problem, we would encourage them to further structure the incentive schemes in such manner as to create greater attraction for the unemployed to seek jobs. We commend the authorities for raising the ODA from 0.29 in 1996 to 0.31 in 1997.

With these comments, we wish the Irish authorities further success in their efforts.

Ms. van Geest made the following statement:

Ireland has been very effective in catching up with the EU. As such, it could be presented as an exception to the generally lackluster performance of regional development policies in the EU. The fact that regional aid was assisted if not overshadowed by sound fiscal policies, exchange rate based nominal stabilization wage moderation and a friendly investment climate will have something to do with that.

I commend the authorities for raising interest rates in response to the depreciation of the Irish punt, as a weaker punt could give rise to inflationary pressures. Monetary autonomy may become more and more circumscribed in the progress toward EMU, but the authorities should use the opportunities as they arise. In our view, the fact that the Irish punt is at present valued above parity does not provide a reason to ease monetary policy.

I would be less sanguine than the authorities regarding the spillover effects of rising asset prices. Dutch experience in recent years shows that the effects from wealth increases on consumption growth can be substantial. Should such wealth effects materialize in Ireland as well, housing price inflation could have an effect on the general price level, if capacity constraints occur. I would furthermore like to stress that asset backed loans may become more risky in an environment of unwarranted increases in asset prices. In this respect, I share the concern of the Irish authorities that borrowers and lenders may mistakenly assume that interest rates could only decline.

Ireland has been so successful in the budgetary area that together with Luxemburg it has the rare privilege of never having had an excessive deficit, at least in view of the Council, and as such was among the first to have real confidence in its ability to join EMU in the first wave. However, having reached the front of the field does not mean that efforts can be relaxed. Ireland could very well face a reduction in EU transfers, with its success in the area of nominal and real convergence. Moreover, the Pact for Stability and Growth sets clear targets for the budget in the medium term. In previous calculations, the European Commission already indicated that the cyclical component of the Irish budget was over 3 percent in the period 1976–1996. Against this background, Mr. O'Loghlin's statement that the new government aims for a balanced budget over the next years two to three years is encouraging. I did wonder, however, how confident the authorities are that they will be able to maintain the expenditure ceilings, while their predecessors could not.

In addition, I was wondering to what extent the authorities had switched strategy more profoundly. Up until now, fiscal policies seem to have been rather procyclical in nature, with spending increases and tax incentives in times of economic prosperity and the belt being tightened in times of adversity. Now, the former government prided itself on its ability to keep the deficit low when macro economic conditions were weak. While no doubt admirable, it is hardly a policy economists would advocate as a first best strategy. Obviously, the need for an a-cyclical or even anti-cyclical approach to fiscal policy clearly becomes even more pronounced, once Ireland enters Economic and Monetary Union.

Despite Ireland's attractive employment growth over the years, unemployment remains high. As in the case of the Netherlands, the performance is more impressive in terms of flows than in terms of stocks. I agree with staff's recommendation that unemployment benefits should rise less than wages to strengthen work incentives. I also agree that tax relief should be focused on reducing the high marginal rates faced by those entering into low-paid jobs.

Mr. O'Loghlin indicated this morning that his authorities intend to introduce a minimum wage. I can sympathize with the thought. However, it will be important to set the level of this minimum wage at a prudent level, in line with the productivity of job seekers at the lower end of the labor market. Lower skilled unemployed will hardly be helped, if the barriers to their entrance in the labor market become even higher. And reducing a minimum wage and associated benefits if set at an imprudent level can be a painful process as my own country's experience shows.

In addition, staff notes in its paper that long term unemployment remains relatively high and mentions older displaced workers and early school leavers as two problem groups. In the Netherlands, a graduating scale of youth minimum wages and benefits has proved very effective means to tackle the problem of youth unemployment. I would hope that the new Irish government will consider this approach as well, when it designs its minimum wage policy.

I read with interest staff's background paper on Ireland's participation in EMU. In addition to thé description of a welcome study commissioned by the authorities into the effects of Ireland's participation in the case the United Kingdom avails itself of the opt out clause, staff has undertaken some analysis of its own, regarding Ireland's susceptibility to asymmetric shocks or diverging economic developments in EMU. The results seem to confirm to a certain extent expectations that Ireland's economic performance might be slightly out of sync with that of the rest of the EU. However, I found the econometric work difficult to gauge; first of all, it might be more useful to assess Ireland's performance vis-à-vis the performance in the prospective EMU area as a whole as opposed to Germany (or any other state for that matter) alone, as it is the general economic situation in EMU that will determine the monetary policy stance in the third stage. I think you cannot deduce that from the bilateral results presented as a consequence of aggregation issues. The analysis vis-à-vis Germany alone, on the other hand, would seem more relevant for the present ERM set up. In addition, the period 1980–1996 may gloss over a break in the series, as a result of Ireland's shift in economic strategy in 1987. Finally, the results lead staff to conclude that there is an optimal currency area in the EU that includes Germany and Belgium, but not the Netherlands. Now this is a refreshing new thought, but to me it would suggest that it might be useful to reconsider the study.

Despite all this, I would agree with staff's conclusion that the loss of the exchange rate could present challenges and I already noted the need for a more a-cyclical fiscal policy. In addition, I agree that labor flexibility is important, but on this issue Ireland with its flexible labor supply would seem to be a happy exception to the EU rule. In addition, more may need to be done in the area of product markets and I was therefore hoping that the new government may be more ambitious in the area of privatization than its predecessor.

I noted that the last Board discussion did not put staff's fear to rest that the ECB might have a bias toward tight monetary policies, to assert its credibility. I would just like to underscore that this view is obviously not shared by this chair.

I would be interested to hear whether the Irish authorities intend to follow the precedents set by other EU members and issue a Press Information Notice (PIN).

Mr. O'Donnell made the following statement:

We commend Ireland for yet another year of impressive economic performance. Economic output continues to catch up to production levels in neighboring countries, with real GNP growth likely to exceed inflation for the fifth consecutive year; unemployment—although still high—is falling rapidly; job creation is strong; and nominal inflation remains low.

I agree with much of the analysis in the staff papers, including the assessment that the main challenge the authorities face is to maintain their favorable performance, and to keep policies oriented toward EMU entry and achievement of the Stability and Growth Pact. In the short term, guarding against a build-up of inflationary pressures will be a key priority, particularly given the upward trend of traditional indicators such as housing prices. Over the medium term, the priority is to make further progress in reducing the economy's structural rigidities and to strengthen market-based incentives.

I have been puzzled by the fact that, despite the sustained stance of prudent economic policies and strong performance as measured against the Maastricht criteria, calculated probabilities of Ireland's participation in EMU have, until recently, placed Ireland as an outsider for early entry. I find it similarly puzzling, again in light of Ireland's prudent policy stance and what would appear to be strong prospects for early EMU participation, that long-term interest rates in Ireland have remained so high for so long.

Newly emerging inflationary pressures need to be curbed, but the traditional approaches of either tightening monetary policy or tightening fiscal policy may be more complicated in the Irish case. Given the relative strength of the Irish currency within the ERM bands, tightening monetary policy could make it difficult for Ireland to enter EMU with an exchange rate that allows for the required adoption of identical short-term interest rates across participating countries. The close link between Ireland and the United Kingdom in terms of exchange rates—with both currencies likely to be overvalued—reinforces policy constraints. I would be interested in staff views on how the authorities should proceed in those circumstances. If the solution is not to raise short term interest rates as much as might otherwise be the case with full monetary policy autonomy, the question is how to design fiscal policy. The potential on the fiscal side is that policy would be tightened at a time when, by nominal criteria, it already looks to be quite tight.

Nevertheless, greater reliance on fiscal policy is warranted. In that regard, the envisioned small increase in the general government deficit is disappointing. Although the level of the general government deficit remains low, the size of the structural deficit is unclear. Traditional approaches to cyclical adjustment—which rely on measures of output gaps, for example—may not be as fitting in a high-growth economy. Given the constraints on monetary policy, I would argue for slightly more ambitious fiscal targets.

The importance of tax cuts in delivering the agreement on the social pact places the burden of deficit reduction on expenditure restraint. Enhancing the efficiency of the unemployment benefit system is one obvious target for expenditure reduction. With roughly 25 percent of those claiming unemployment benefits estimated to have withdrawn from the labor force and another 11 percent estimated to be working full time, increasing incentives to seek and officially accept jobs is a top priority. Health care costs could also be consolidated by implementing the OECD recommendations to improve the management of hospital budgets through greater decentralization of budgetary control.

Reform of the tax system is also needed to improve incentives to work and to reduce the extent of poverty traps. The government is taking steps in the right direction, but a bolder approach is warranted. Both the staff and the OECD have pointed to the need to unify the personal tax allowance and the income tax exemption limit to reduce the bias in favor of the unemployed in the child allowance system, and to reform the housing support system to reduce the disincentives to work.

> The combination of inflationary worries and constraints on monetary policy underscores the need to ensure wage moderation. Recent pressures from trade unions—both public and private—for wage increases beyond those agreed in the Program 2000 are worrisome. Such demands must be resisted, given Ireland's still high, although admittedly falling, unemployment. Otherwise, the ensuing victory of insiders over outsiders in the labor pool would hinder the authorities' efforts to increase social cohesion. It is important that that message is strongly conveyed to the public, both by the authorities and by the Fund. My hope would be that a PIN is published, both to improve openness and transparency of policy, and to highlight the particular need for wage moderation given Ireland's high unemployment and unique policy environment.
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> The background paper on Ireland's participation in EMU illustrates that EMU analyses should not be based on the concept of optimum currency areas. The United States, for example, is not an optimum currency area, and certain countries within the EU do not qualify for optimum currency status. Far more important is whether the group of countries in question constitutes a "viable currency area," and precisely what economic reforms prior to EMU entry would make EMU workable.

Mr. Daïri remarked that Executive Directors had agreed not to exert pressure on other members regarding publication of PINs. While his chair was not against publication of PINs in principle—Tunisia, a member of his constituency, had been one of the first members to publish a PIN—pressure on Directors to state their intentions with respect to publishing PINs should be avoided pending further consideration of that matter by the Executive Board. Questions regarding possible publication of a PIN could instead be addressed to the staff, whom the member in question might or might not have indicated its intentions in that regard.

The Acting Chairman considered that a polite question from one colleague to another did not constitute pressure.

Mr. Donecker remarked that Executive Directors should not be pressured to state a member's intentions. The timing of such announcements should be left to members to decide.

Mr. Sobel agreed with the Acting Chairman that a neutral question from one Executive Director to another did not constitute pressure. Nor did a chair commending a country for having consented to issue a PIN—as his chair had done in the case of Tunisia—constitute pressure.

Mr. O'Loghlin stated that he had regarded such inquiries as expressions of friendly interest and, perhaps, as indications of what people thought best for Ireland. While he could not provide a definitive response prior to the authorities having seen the draft PIN, he anticipated a positive outcome.

Mr. Giustiniani made the following statement:

> Over the recent years, the macroeconomic performance of the Irish economy has been striking. In the early eighties, Ireland was lagging behind many other European countries. Per-capita income was about two-thirds of the

European average. The inflation rate was among the highest. The budget deficit as well as the current account deficit were ranging around 10 percent of GDP. The general government debt/GDP ratio was on an upward trend. After a first attempt at macroeconomic stabilization, in the mid-1980s the course of the Irish economy experienced a significant turn-around. Today Ireland is considered one of the most dynamic and successful economies in Europe; an economy that has succeeded in combining a fast expansion in production activity, and hence in job creation, with a declining inflation rate and with a substantial correction in public finances. These years also witnessed a marked shift in the production structure of the Irish economy, with a decline in the share of GDP accruing to agriculture and fishing as well as to traditional manufacturing sectors and a rapid increase in the weight of high technology activities.

This favorable outcome is the result of the interaction of several factors. A sound macroeconomic management together with an effective incomes policy, which allowed continued wage moderation and an extended period of social consensus, generated an environment conducive to a very favorable supply response. The substantial inflow of foreign direct investment, attracted by a rapid increase in the size and quality of the labor supply and by a favorable tax regime, was the main driving force behind this positive supply response.

As rightly emphasized by the staff, the main challenge for the Irish economy is to endure along this virtuous path. In this regard, some questions arise about the outlook of the economy both in the short and the medium term. Let me start from the latter. The excellent performance of the Irish economy in the last ten-fifteen years may be interpreted in terms of the standard neo-classical model of economic growth, i.e., economies with lower level of capital per worker tend to grow faster in per capita terms and hence to converge toward the richer nations. Given the considerable degree of nominal and real convergence with the most productive EU partners achieved by Ireland over the last decade, for instance in terms of per capita income or in terms of capital income share in the business sector, we wonder whether the process of catching-up is about to decelerate. In other words, we wonder whether this simple evidence may hint that Ireland is approaching a stage of maturity in its process of development. Or, on the contrary, we wonder whether it would be possible to argue that the economies of scale associated with the concentration of firms in high-technological industries may be a sufficient source of continued innovation and growth—supported by the continued inflow of foreign direct investment. Which of the two scenarios is the most likely to prevail?

As far as short-term perspectives are concerned, the main challenge to Ireland's economic performance is to avoid a rekindling of inflation. Signals of overheating are already present: the economy is running at, or slightly above, its potential; wage growth has edged up; pressures in the real estate market have strengthened, domestic credit has expanded rapidly. The recent increase in official interest rates is therefore to be considered an appropriate reaction by the monetary authorities. However, the room for maneuver of monetary policy finds its limit in the current strength of the external value of the Irish punt, as Mr. Andersen pointed out. Further increases in interest rates can strengthen upward pressure on the exchange rate. In such circumstances, fiscal policy should complement and support monetary policy in keeping inflation low. In this regard, while we welcome the decision of the Irish government to cast the 1997 budget within a medium-term framework, the envisaged fiscal objectives fall short of expectations. Although the 1997 budget deficit may turn out to be lower than expected owing to the continued buoyant expansion of economic activity, the front-loading of tax and spending measures is projected to generate a deterioration in the structural component of the deficit and a small reversal in the downward trend in the debt/GDP ratio. Apart from possible considerations related to the fulfillment of the stability pact over the cycle, this expansionary stance of fiscal policy seems to be unnecessary, given the ongoing strong performance of the economy: private consumption and investment are in fact expected to continue to expand at a rapid pace. As far as the first component of domestic demand is concerned, I noticed that in recent years the growth in private spending was associated with a declining trend in the households' saving rate. This feature is common to other European countries. However, while in most of these countries the decrease in private saving was triggered by a low growth, or even a decline, in disposable income, in the case of Ireland that trend has been accompanied by a continued increase in disposable income. This seems to point out a clear shift in households' revealed preferences from saving toward consumption. This evidence leans to strengthen the argument in favor of a withdrawal of the expansionary impulse generated by the current stance of fiscal policy. In this regard, I agree with the suggestions put forward by the staff. I wish just to underline that a further overhaul of tax and social welfare system is also instrumental to firmly address the problem of structural unemployment, still high despite the significant improvements achieved over the last years.

A more ambitious fiscal consolidation in conjunction with a more flexible labor market will contribute to strengthen Ireland's already impressive economic performance.

With these remarks I wish the authorities all the best.

The staff representative from the European I Department, addressing questions related to Ireland's potential participation in EMU, noted that the relevant passage in the background paper, to which Ms. van Geest had referred had been intended only to summarize the results of some simple correlations, and did not represent a judgment on which members of the EU or which parts of members constituted an optimum currency area. He agreed with Mr. O'Donnell's arguments about the limitations of analyses based on such correlations, but those issues were outside the scope of the staff background paper.

Regarding Ms. van Geest's question whether that study's results would have been different had the reference period been split up to take account of the shift in Ireland's economic policy in 1987, the staff representative noted that the staff had, indeed, looked at correlations for those subperiods. Restricting the reference period to the post-1987 time frame led to a higher correlation of Ireland's industrial cycle with Germany; in absolute terms, however, the correlations were still quite low.

The staff had not intended for the background paper to forecast the interest rates to be set by the ECB, the staff representative continued. Rather, the authorities' study of Ireland's participation in EMU had assumed that Irish interest rates would converge down all the way to German rates. That scenario constituted an upper bound on the benefit that would come from lower interest rates through EMU participation. Although the background paper had noted the possibility that benefits could turn out to be smaller under an alternative scenario, that alternative scenario was not in the staff's view the most likely one.

The implications of Ireland's entry into EMU—particularly as regards monetary conditions—were difficult to assess, the staff representative remarked. Although most speakers had seemed to assume that Ireland would enter EMU at the central rate, and hence that the Irish exchange rate would depreciate from its current level within the ERM, the precise procedure for locking exchange rates prior to EMU had yet to be decided. The various possibilities in that regard had been detailed in the staff's recent EMU seminar paper (SM/97/87).

The background paper on Ireland's entry into EMU had highlighted concerns expressed by the Irish authorities that—assuming that relationships between major currencies, specifically between the pound sterling and the deutsche mark, remained stable—Ireland's entry into EMU at the current central rate would imply a significant depreciation of the exchange rate, thereby adding to pressures in the economy, the staff representative continued. In that context, Mr. O'Donnell's remark that both the pound sterling and the Irish pound were overvalued should be qualified. Although the Irish pound was perhaps somewhat overvalued against the deutsche mark, he did not consider that it was overvalued in effective terms, if one accepted the premise that the sterling was overvalued against the deutsche mark. Strong fundamentals in the Irish economy over a sustained period had allowed a trend appreciation of its effective exchange rate. That trend had continued until the second half of 1996; since then, the exchange rate had weakened somewhat in effective terms.

The scope for raising revenues through higher corporate taxes was constrained by the fact that the 10 percent tax rate on manufacturing and international financial services was embodied in long-term commitments through 2010 and 2005 respectively, the staff representative noted. The authorities would consider any revenue benefits from breaching those commitments to be outweighed by the resulting loss of credibility, and rightly so.

With respect to the issue of Ireland catching up in economic terms to its EU neighbors, prospective trend increases in factor supplies indicated that Ireland was positioned to enjoy well above average EU growth rates of GDP, the staff representative said. Per capita comparisons were more complex, for various technical reasons involving GDP versus GNP. It should also be kept in mind that the EU average, in terms of per capita income, did not constitute an unbreachable upper bound, given that that "average" incorporated a wide variation between the highest and lowest per capita incomes within the EU.

Ms. van Geest noted that her remarks on the EMU paper had been of a cautionary nature. While her chair did not object to the paper, close scrutiny raised questions about the analytic approach taken in the paper—the subtleties of which might not be clear to the general public. Her statement regarding the paper's reference to the ECB had been based on the contrast between the staff's potentially judgmental comments on how the Irish study had been carried out, compared with the otherwise descriptive nature of that section of the paper.

Mr. Iradian made the following statement:

Like previous speakers we commend the Irish authorities for the impressive performance over the past decade. We believe that this performance is likely to continue over the medium-term with growth rates well above the OECD average. In what follows, I will touch briefly on the question of overheating, the fiscal situation and the unemployment problem.

On overheating, we find it very hard to pass a judgment on whether the Irish economy is now operating close to its potential. There are high degrees of uncertainties in the estimates of potential output, particularly in the case of Ireland given the continued rapid increase in the labor supply and the extreme openness of the economy. Also, the 12-month inflation rate remains less than 2 percent with no clear sign of generalized price pressure. A continued increase in foreign investment in the nontraded sector is enhancing competitiveness and keeping margins in check. However, we wonder whether possible inflationary pressures could emerge as evident from the recent sharp increases in monetary aggregates. Here I would also seek staff views on whether the pressures that are emerging in the residential real estate market might spill over into wages in the construction sector and then into the rest of the economy. Given these considerations and the need to meet the exchange rate objective, the recent tightening was appropriate and there is no need, at this stage, for a change in the monetary stance.

In the fiscal area, like previous speakers we encourage the authorities to aim for more ambitious targets, for 1998 and beyond, than those of keeping the budget deficit at 1.5 percent of GDP. This could be accomplished through further spending cuts, including changes in the unemployment benefit system and health expenditure, while reducing the tax burden further. Such an approach could, on balance, have a positive impact on economic growth and the budget, and would ensure further significant and lasting reduction of the public debt relative to GDP, which is still relatively high at about 73 percent.

Ireland's major challenge is the labor market. While the unemployment rate declined significantly in recent years it still remains relatively high at about 12 percent. High marginal tax rates have indeed tended to reduce work incentives, particularly for the low-skilled group. The potential earnings of this group are low relative to the permanent flat-rate unemployment support. In this respect, overhaul of the tax and social welfare system together with stricter enforcement of eligibility rates and training programs would give the low skilled group more incentive to work. With these remarks we wish the authorities continued success.

Mr. Han made the following statement:

The comprehensive achievement in Ireland's economy should be credited to the authorities' well designed and implemented strategy of macroeconomic stability characterized by the opening of the economy and promotion of its service sectors. To this end, deep structural reform has shaped the economy by adapting itself to deindustrialization and enabling Ireland to be less burdened with structural rigidities and, therefore, take full advantage of the cyclical upswing. Such growth momentum in turn enabled Ireland to withstand the adverse economic cycle in Europe and create more jobs. Since I found myself in much agreement with the staff appraisal, I will only make a few remarks on monetary, fiscal, and structural issues.

Sound fiscal performance is the main and most important aspect characterizing Ireland's current favorable economic situation. In general, I commend the authorities' prudent fiscal consolidation strategy, which has resulted in the steep decline in government debt. As staff suggested, the much lower fiscal deficit benefited from the windfall results of stronger economic growth. The 1997 budget continues to show this favorable trend, notwithstanding the increase in the structural deficit, reflecting the tax reduction package and increases in expenditures. However, I share staff's concern on the reduction in the residential property tax, given that property prices are already high and the economy is now running at full potential.

It is encouraging that the Irish authorities are aiming at a more ambitious fiscal target than the Maastricht criteria in the medium term, and that the new government has established still tighter goals in line with the EU Stability and Growth Pact. We welcome all measures as listed in paragraph 4 of Mr. O'Loghlin's statement.

Turning to monetary and exchange policy, the authorities' vigilance against the risk of higher inflation related to strong growth is welcome. The preemptive increase in interest rates has signaled corrective action in this regard. I would like to encourage the authorities to closely monitor monetary development and take prompt action against possible overheating.

Ireland has made significant progress in structural reform, as reflected in the larger share in the service sector rather than in the manufacturing sector. Nevertheless, this effort should be strengthened given the loss of control of monetary policy in the advent of EMU. The labor market problem is still the most challenging issue for Ireland. I would like to note that rapid job creation has not been matched by unemployment reduction. The dominance of long-term unemployment in total unemployment points to the need to improve work incentives and tighten benefit eligibility. The authorities' strategy to reduce the high marginal tax rates, combined with the reduction of the replacement ratio is welcome. However, since there has been less progress in the decline in the replacement ratio than in the tax wedge reduction, it is crucial to match these two efforts with the least impact on the budget.

Furthermore, I share with the staff that supervision of financial institutions, especially credit institutions, should be given more emphasis given rapid credit growth, rising asset prices, and competitive pressure in the financial sector. This is particularly so, given Ireland's rising importance as an emerging European financial center. Maybe staff can elaborate more about how Ireland's banking supervision activities will be adapted to the development of financial markets and the EMU.

With these remarks, I commend the authorities for their remarkable economic achievements and wish the authorities further success.

Mr. Lushin made the following statement:

I agree completely with those Directors who commended the Irish authorities for an excellent economic performance of their country during the last years. It is especially notable that the highest long-run growth rate in the EU was achieved by Ireland within a framework of low inflation, moderate budget deficit and sound current account position. Also impressive is the fact that these results have been obtained in a very open economy, where exports account for nearly 87 percent of domestic output, while imports amount to 84 percent of aggregate domestic consumption in 1997. The Irish economic triumph is based on a solid background of a highly competitive manufacturing sector, specializing in production of high-tech goods. The case of Ireland may serve as a textbook example of how a prudent policy, focused on inward foreign investment in dynamic, export-oriented activities, could let a country reap the benefits of globalization and technological change and hence, increase the prosperity of population. The staff papers show that the attractiveness of Ireland to foreign investors is deeply rooted—first and foremost it is based on a stable macroeconomic environment, low unit labor costs due to wage moderation, financial discipline and sound monetary policy.

There is indeed not much to add to the staff papers and the views expressed by the previous speakers, so I will limit my comments to only a few points.

Continuing decrease in the U.K. share of Irish foreign trade indicates that diversification of the Irish economy is going on, which is welcome. At the same time, trade shares of other EU countries as well as of the United States and Canada remain relatively stable from 1990. In this regard, I would like to ask the staff what are the new rapidly growing markets for the Irish trade expansion? Within the ERM, the Irish pound fluctuated sizably against its central rate in 1995–97, and also against the DM, which is explained by still existing link between the punt and the sterling. Under EMU, pressures on the punt resulting from sterling fluctuations against the euro could become even stronger, provided that the United Kingdom would not participate in the Union from the outset. In this respect another question arises, namely, may such developments exert a negative impact on the Irish economy, taking into account that the United Kingdom is still number one trade partner for Ireland?

Starting from the middle of 1996, Irish long-term interest rate differential over German yields narrowed to less than 1 percentage point, which is rightly treated in the staff's paper as a signal of increasing investor confidence in Irish EMU entry. However, the uncertainty about the eventual entry rate of the Irish pound into EMU caused markets to speculate sharply against the punt twice in 1997, with the authorities' response being the increase of official interest rates by 50 basis points in May 1997. I praise this step of the authorities, aimed at strengthening the exchange rate in order to preserve the current low level of inflation. I was also encouraged to learn from

Mr. O'Loghlin's informative statement that the authorities will not hesitate to tighten the monetary stance should signs emerge of a pickup in inflation.

Ireland has demonstrated an impressive fiscal policy track record of low deficits and rapidly decreasing debt ratio. This long-lasting trend is supposed to be extended in future, with the deficit not exceeding 1.5 percent of GDP for the next few years. At the same time, the staff is absolutely right that a more ambitious approach could be warranted, especially in view of the expected phased reduction in EU transfers to Ireland after 1999. However, Mr. O'Loghlin assures us in his statement that the authorities are well aware of this problem and are already taking preventive measures to defend or even to enhance the present fiscal performance (for example, by limiting growth in current expenditures to 4 percent annually in nominal terms).

Although the short-term unemployment rate in Ireland is below the OECD average, long-term unemployment among low-skilled workers still remains a problem. However, according to Mr. O'Loghlin's statement, this issue is being addressed by the authorities "as best it can," both through creating better work incentives and by programs of activation, aimed at the long-term unemployed and young people with few qualifications. Given this firm commitment of the authorities, I believe that eventually the announced programs will bring fruit.

With these remarks, I fully endorse the staff appraisal and wish the Irish authorities further success, especially in the light of the EMU challenge.

Mr. Al-Turki made the following statement:

Ireland's impressive economic performance continues. Last year, growth was again robust and broad-based, inflation decelerated below 2 percent and, for the fourth successive year, unemployment declined. The challenge is to preserve these trends. I agree with the staff recommendations in that regard and will only add a few remarks for emphasis.

The Irish success is a further demonstration of the overriding importance of macroeconomic balance, an open trade and payments system, a favorable debt profile, and structural reform. The authorities' commitment to maintain this policy stance is thus reassuring.

Being already at an advanced stage of the upswing, Ireland has to be watchful for signs of overheating. In that connection, the authorities are to be commended for the astute efforts to contain high wage expectations. I welcome especially the enhanced public focus on whether an output increase is from higher productivity or a rise in employment. The consensus on the critical importance of continued competitiveness also is encouraging.

As Mr. O'Loghlin points out, it is important to note that underlying the moderate long-term rise in overall employment is a significant shift of labor from agriculture to the rest of the economy. The challenge now is to accelerate improvements in the incentive structure for a fuller and more efficient use of the labor force. I therefore welcome the various initiatives detailed in the staff report, including the steps to upgrade the skills of the long-term unemployed. A speedup of the proposed integrated approach to tax and welfare benefits is a priority.

Finally, it is indeed commendable that Ireland's official development assistance has more than kept up with the economy's rapid expansion.

With these remarks, I wish the authorities further success.

Mr. Daïri made the following statement:

I congratulate the Irish authorities for their impressive macroeconomic performance during the last decade as evidenced by strong economic growth that has closed the gap in per capita GDP with EU average levels in a low inflation environment and has put Ireland among the front runners for EMU participation. Moreover, while still at a relatively high level, unemployment has declined rapidly from the peak it reached in the early 1990s. These achievements stem from the authorities' stabilization and reform efforts that have contributed to attracting foreign direct investment in fast growing, labor-intensive, export-oriented sectors. I thank the staff for an excellent set of papers and concur with the thrust of their appraisal.

Since 1987, fiscal policy in Ireland has been exemplary. It has achieved a turnaround in debt dynamics from a deteriorating to rapidly improving cycle and, as indicated by the staff, has been central to the social consensus on macroeconomic policies. Observance of the Maastricht deficit reference in 1997, as well as achievement of the medium-term fiscal targets set in the Stability and Growth Pact seem largely within reach when looking at fiscal performance of the 1990s. However, I share the staff's view on the vulnerability of fast-growing countries like Ireland to abrupt changes in the pace of growth. It is noteworthy that in 1996 general government deficit was lower than budgeted by 1.7 percent as a result of stronger growth performance which indicates the magnitude of possible downside risks. In this regard, one wonders whether the allowances for contingencies of 0.3 percent of GDP in 1998 and 0.6 percent of GDP in 1999, built in the medium-term fiscal framework, are sufficient. The high degree of openness of the Irish economy and the expanded role of fiscal policy as the major macroeconomic policy instrument that would follow EMU membership would also suggest stronger fiscal consolidation. Moreover, the authorities would be well-advised to leave room in the fiscal position to face any short-term effects of EMU membership on the exchange rate and interest rates, as well as a possible decline in EU transfers. I appreciate some indication from the staff on the treatment of EU grants and subsidies amounting to 5.0 percent of GDP in the fiscal accounts. I am pleased to learn from Mr. O'Loghlin's helpful statement that the new government has established tighter fiscal goals for the medium term.

Tax policy in Ireland is a good example of what can be achieved through a combination of well tailored tax cuts and efficient administration. The reduction in income and corporate taxes is appropriate and has contributed to improving business environment and employment incentives. However, in view of the authorities' intention to continue with reduction of the standard corporate tax rate, it is important to know how tax policy would be adjusted should fiscal developments turn out to be less favorable than expected. I wonder if there is room for an increase in the rate of the value-added tax and expansion of its coverage to include goods subject to some of the low buoyancy excises. I welcome staff's comment on the elimination of the advance payment for the value-added tax that reduced revenue collected in 1996 and would increase the 1997 revenue by some 0.6 percent of GDP and how this could affect observance of the Maastricht deficit reference as well as revenue developments beyond 1997.

The increase in housing prices needs to be carefully monitored in order to protect against unexpected decline in asset prices. The staff indicates that the central bank has recently taken action to ensure that credit standards are maintained and a new regulation requires mortgage lenders to warn borrowers about interest rate risk. Could the staff comment on whether a prudential regulation requiring higher down payments from buyers would contribute more efficiently to moderation in house demand? Incidently, the Appendix Table A30 of the background paper, while showing the large increase in the share of credit to personal services in 1995 and 1996, does not indicate the sectors that experienced a corresponding drop in their credit share. It seems that contrary to 1995 and 1996, sectoral distribution in 1994 does not add up to total credit, but represents only some two-thirds of the total.

Like Mr. Disanayaka, I commend the Irish authorities for the increase in ODA and encourage them to continue to move toward achieving the UN goal of 0.7 percent of GDP. I wish the Irish authorities every success in their endeavors.

Mr. Lucenti made the following statement:

I would like to commend both, the staff for a well-written set of papers, and the Irish authorities for the excellent results in raising the country's living standards toward the EU average. In the last few years, the economy has been showing a rapid rate of growth and low inflation which have been possible thanks to the implementation of a tight fiscal and monetary policy and the concurrence of several aspects, namely: a social consensus on an economic strategy, access to globalization and technological changes and a rapidly growing and skilled workforce. This strong performance will make Ireland suitable to qualify for EMU entry.

The authorities are also committed to maintaining this favorable performance in the period ahead. In this regard, I welcome the presentation of the 1997 budget in a medium-term framework which will increase fiscal transparency and will settle down expectation about the future policy orientation.

Since I broadly share the staff's appraisal, I would like just to emphasize two aspects of the staff's report. First, the buoyant economic activity and the borrower's expectations of lower interest rates in EMU have expanded the private sector credit which accelerated to more than 18 percent in the year through the first quarter of 1997. This is a situation that should be closely monitored by the central bank looking for signs of upward pressure on inflation. In this regard, I welcome the recent measures taken by the central bank to ensure that credit standards are maintained.

Second, the staff warned that there is a risk that the recent wage settlement for nurses may give rise to inflated pay expectations in other public sector groups with spill-over effects to private settlements and adverse consequences for competitiveness and economic activity. Mr. O'Loghlin in his statement assesses that restraint of public sector pay is implicit in the incoming government's budgetary objectives and gives some arguments that the government may use not to grant a wage increase beyond the lines of the consensus. For example, the larger part of growth in recent years reflects rising employment and is not attributable to those already employed. In an economy where trade represents 150 percent of GDP, international competitiveness must be jealously guarded. I wonder whether these same arguments could have been used to avoid the significant award made to nursing staff. There will probably be pressure for wage increases beyond the limits established in the consensus; however, the government must resist them and I am glad it is committed to do so.

Again, I commend the authorities for the excellent economic performance and wish them every success in their future endeavor.

Mr. Sobel made the following statement:

The staff observes that Ireland's economic performance over the past decade has been spectacular. We broadly concur with the judgment and Ireland's performance speaks for itself, so I will be brief.

First, we commend the authorities for their efforts to forge an outward-looking policy, coupled with disciplined macroeconomic and wage policies. Ireland's robust growth and quick convergence toward average EU income levels attest to the miracles of compounding and the benefits of taking advantage of the forces of globalization.

Second, one of the very positive features of the surge in growth is the strong rebound in employment creation, buttressed by the authorities' efforts to build a social consensus to support wage moderation, while tackling tax and structural rigidities to the efficient functioning of labor markets. Chapter 3 of the selected issues offered useful background on this latter point and, while there is more to be done, one wonders whether there might be something here to be learned by others.

Third, we would join the staff in welcoming that the 1997 budget is the first to be explicitly couched in a medium-term fiscal framework. Also, it is noteworthy that fiscal discipline has been preserved and tax revenues broadly sustained relative to GDP, despite tax cuts, due to the economy's robust growth.

Fourth, I had two questions for the staff. I noted the staff's concerns on overheating and potential price pressures, given the strong growth of recent years. But I have sympathy for Mr. Iradian's views on these points. I would assume that the staff's concerns to some degree hinge on its expectations regarding productivity and unit labor costs. Appendix 1 leaves one with the impression the staff may expect medium-term productivity growth of 2½ percent but the potential for a large increase in labor supply becomes high both from increased participation and lower unemployment. Could the staff elaborate on its views and the potential upside and downside risks on future Irish productivity growth? Also, I noted that public spending is around 43 percent of GDP, a lower amount than in many European countries, but higher than in many others. Would the staff or the authorities have a view on whether public sector spending is too large or about right?

In closing, we commend the authorities again for their outstanding record and for earning the moniker of "spectacular" from Fund staff.

Ms. Cilento made the following statement:

As others have noted Ireland's economic performance has been impressive to say the least—and the ability of the economy to adapt to the changing opportunities provides a lesson from which many of us could benefit. The performance of the economy clearly demonstrates the benefits of creating an economic environment conducive to private sector growth and employment creation.

While many aspects of this performance are noteworthy, Ireland's record of job creation is especially worthy of comment—in particular given that is has been achieved in conjunction with very strong productivity growth. One of the major challenges for the authorities will be to ensure that employment growth can be sustained. This will require efforts to further promote flexibility in both product and labor markets.

In terms of the labor market, the centralized wage fixing system has served the authorities well. I suspect this is, at least in part, because the system incorporates elements allowing some flexibility in wage determination at the local level—including allowing for flexibility in terms of local productivity improvements as well as in terms of firms' ability to pay. I was particularly interested in these characteristics because a lack of flexibility was a limitation in Australia's Accord system—and is one of the reasons why we have moved toward a more decentralized system.

The challenge will be to ensure that the centralized system continues to serve the Irish economy well, especially in terms of allowing adjustments in wage relativities in line with ongoing productivity developments. The staff notes that if the recent settlement for nurses flows on this will have adverse implications for competitiveness and activity—I would also emphasize the impact on unemployment. It is important for the authorities to avoid wage norms becoming entrenched—and in this regard I welcomed the assurances provided by Mr O'Loghlin in his statement, but the authorities will need to be vigilant on this front.

Notwithstanding strong employment growth, unemployment remains high in Ireland reflecting in part strong growth in labor force participation. While an increase in the labor supply has limited the extent to which employment growth has lowered unemployment—it is by no means undesirable, and the trend looks likely to continue.

This situation underscores the need to address a number of underlying structural issues. While recognizing the authorities' efforts to date, I broadly support staff recommendations regarding the need to address perverse incentives created by the interaction of tax and benefits systems. I would also like to emphasize that if Ireland is going to maintain open-ended unemployment benefits (as Australia does)—the authorities need to ensure that active job searches are maintained. Like Mr O'Donnell, I was surprised to learn that a substantial number of unemployment benefit recipients were either working or not actively seeking employment.

Given that a very high proportion of the long-term unemployed have not completed upper secondary schooling (about three-fourths of long-term unemployed have not), an important key to solving the structural unemployment problem will be improving the employability of those who have already left school and providing the right incentives for young people to stay at school. While the authorities are seeking to address the former through active labor market programs—the latest OECD report on Ireland noted that the effectiveness of some of these is questionable. Mr O'Loghlin noted that his authorities intend to strengthen these measures. On the basis of Australia's experience in this area—I would encourage the authorities to focus their efforts and resources on well-targeted programs which address the specific skill needs of specific groups of unemployed.

On the introduction of a national minimum wage—I have to admit that I considered that the current approach, which allows for flexibility in this area, was appropriate particularly given the youth unemployment problem and I would appreciate staff's views on the issue. As Mrs. van Geest noted, we would urge the authorities to avoid setting up another hurdle for unemployed youth.

Finally, given the authorities' recent track record I am somewhat reluctant to criticize the current stance of macro policies, but on the whole, I tend to agree with others that given the current stage in the cycle, the authorities should consider a tightening of fiscal policy.

With these comments, we wish the authorities every success in building on recent achievements.

Mr. Kpetigo made the following statement:

I would like to join previous speakers to commend the Irish authorities for their impressive economic achievements in recent years, with most indicators moving in the right direction. In particular, I would note that the GNP growth in 1996 remained high, the current account also remained in surplus in five years in a row, and external reserves are comfortable. Inflation as measured by consumer price was reduced further to 1.6 percent. However, notwithstanding that the medium-term fiscal targets are more ambitious than the Maastricht requirement, I can agree with the staff that the main challenge for the Irish authorities is to sustain this remarkable performance during the years ahead, and also to address the employment situation where further progress is needed. In this connection I find myself in broad agreement with the staff recommendations, and also concur with Mr. O'Loghlin that, because of the importance of services in the GDP the authorities should endeavor to preserve the international competitiveness.

I will, however, make a few comments on monetary and exchange rate policy, fiscal policy, and on developments in the labor market.

On monetary and exchange rate policy, I welcome the authorities' focus on the objective of maintaining price stability. Indeed, as the Irish economy is operating at close to its potential, there are risks of possible inflation. In this context, it is encouraging to note that the authorities have planned to cool down the economy. Thus, output is now anticipated to grow at a slower pace for the period ahead although there is no sign of serious pressures on both goods and factors of production in the near future. However, as the EMU outcome could constrain the monetary and the exchange policy, we urge the authorities to continue to monitoring price movements and exchange rate developments. Therefore, I welcome the contingency measures under the consideration by authorities.

As regards the fiscal policy, the strong economic growth recorded in recent years has generated revenue which associated with efforts in expenditure retrenchments has facilitated finance tax reductions. As a result, the overall budgetary situation has continued to improve remarkably. So far, the authorities have successfully implemented a procyclical fiscal policy consistent with the economic growth. I commend the authorities for maintaining a long track record of low budgetary deficits and for continued reduction of the debt ratio. Although this track record provides assurance that the authorities will maintain an appropriate fiscal policy stance, the macroeconomic environment might change with the EMU outcome. The Irish government, therefore, should be prepared to strengthen further their medium-term fiscal framework. This policy requirement would become more compelling with the likely loss of monetary independence to the EMU, in a context where the fiscal burden for Ireland may become high.

On labor market the service sector is the main source of job creation in Ireland, rising at an annual rate of 3.9 percent during 1994–96. However, the decline in unemployment, while significant remains insufficient. We would urge the authorities to explore other avenues to improve the unemployment which remains high. Does the staff have some ideas on ways the authorities can deal with this problem?

I would like to thank the Irish authorities for their assistance to developing countries.

Mrs. Paris made the following statement:

I welcome this well-written report, and as other speakers, I would like to commend the Irish authorities for their skillful management of the economy. I would just make a short comment on fiscal policy.

It makes no doubt that benefits could be reaped from the reduction in the tax burden. In the case of Ireland, this strategy would also be warranted, but the fiscal burden is quite lower than in other countries. Therefore, at the present juncture, in regard to inflationary pressures and the still high structural deficit, the adequate strategy seems to me the reform of the tax structure instead of reducing the tax burden on the uniform basis. I would appreciate the staff's comments on this. Lastly, I would just say that I fully appreciate the staff's comments on the level of the exchange rate since precisely we wanted to question whether the current rate would necessarily be appropriate in the long run in the context of the European Union.

The staff representative from the European I Department noted that the staff shared Mr. Iradian's concern about the risk of spillover from the construction boom to construction wages, and to wages more generally. In the past year or two, construction wages had marginally outpaced wages in other sectors of the economy. Judging from experience elsewhere, those developments should be closely monitored. Thus far, however, generalized wage pressures had not been documented, and the centralized wage agreements had been observed.

The staff's assessment of productivity growth was probably conservative, the staff representative continued. The authorities' medium-term plans were based on productivity growth assumptions in the 4 to 5 percent range. The staff considered that approach to be prudent, given that some other assessments projected productivity growth over the medium term of 5 to 5.5 percent, or more. Any assessment of the contribution to productivity of the improving educational quality of the labor force was subject to considerable uncertainty, however, given that the average educational attainment of those currently entering the labor force was higher than that of those who were leaving the labor force. The continuing effect on Irish productivity of foreign direct investment, and whether foreign investment would continue at its recent pace, also remained in question.

The staff's understanding was that banking supervision in Ireland already conformed to the relevant European Union directives, the staff representative stated. Membership in the EMU should not by itself occasion changes in the regulatory framework.

The strength of property markets in Ireland reflected the fundamentals of demand and supply—particularly given the flow of Irish citizens returning from abroad and seeking housing—rather than an asset price bubble, the staff representative considered. Lenders appeared to be protected against risks, in that the average loan/value ratios in all portfolios were well within comfortable margins.

Ireland had done well in expanding its exports to Asian countries and to transition economies, the staff representative noted, which might have reflected Ireland's policy focus on globalization. Recent investments had been concentrated in products that were sold in a wide variety of markets, including markets that were just starting to grow.

With respect to Mr. Daïri's question about the treatment of European Union transfers in the fiscal accounts, about half of the total of European Union transfers was payments to farmers under the Common Agricultural Policy, and hence did not enter the fiscal position in any way, the staff representative said. The Structural and Cohesion Fund payments appeared as resources for the capital budget in the fiscal accounts, and the expenditures to which they contributed were reflected on the expenditure side.

Mr. Daïri noted that he had not seen a significant level of nontax revenues reflected in the overall amount of fiscal revenues.

The staff representative from the European I Department replied that those structural receipts were reflected in the capital resources category. From a policy standpoint, the key issue would be the need for the authorities to adjust if those funds were to decline after 1999. Those considerations had been factored into the authorities' medium-term plans.

The change in the method of payment of value-added tax simply entailed a timing effect from one year to the next and did not have any medium-term implications, the staff representative continued. Nor was that change connected with efforts to meet the Maastricht deficit ceiling in 1997, which the staff believed Ireland would accomplish easily, even on the basis of the previous payment method.

Mr. Daïri, noting that he did not doubt Ireland's ability to meet the Maastricht criteria, remarked that the change in the payment method of the value-added tax—as described in the staff paper—appeared to have resulted in a significant increase in value-added tax collection in 1997. Unless some sort of reclassification had been introduced, revenues in 1997 would seem to have been artificially increased by some 0.6 percent of GDP compared with those in 1996.

Mr. O'Loghlin responded that the revenue yield in 1997 had not been artificially boosted. Rather, the increase reflected revisions to value-added tax collection patterns over the years. Several years previously, the authorities had collected 14 months worth of revenue to assist the budget at less fiscally responsible times. Three or four years earlier, and then again in 1996, collection had been cut to 11 months. In both 1995 and 1997, 12 months worth of value-added tax had been collected.

Mr. Daïri wondered whether the elasticity of the tax system would improve if the coverage of the rate of the value-added tax were increased and the coverage of that tax were extended to include goods subject to some of the low buoyancy excises.

The staff representative from the European I Department responded that the Irish value-added tax system had both broader coverage and a higher rate than that of the United Kingdom, for example. Whether scope existed for an increase in the already high value-added tax rate was largely a question of political judgment.

The authorities aimed to keep public spending growth in real terms to about 2 percent a year, which, given the trend growth of the economy, was leading to a modest trend reduction in the expenditure/GDP ratio, thereby facilitating tax reform efforts, the staff representative noted. Over the past 10 years or so, the reduction in the spending ratio had been quite dramatic and seemed to have served the authorities well in terms of economic performance over that period.

With respect to Mrs. Paris's question about reform of the tax structure versus more general reductions in taxes, the staff representative continued, the staff would have preferred to have seen the tax reductions in the 1997 budget somewhat more focused on addressing the issue of work incentives for the low paid and the long-term unemployed, and perhaps a bit less on more general income tax rate reductions.

The staff had only recently learned of the new government's intentions regarding the minimum wage, the staff representative remarked. As Mrs. van Geest had already mentioned, any introduction of a minimum wage should be handled carefully in order to minimize the adverse impact on incentives. Tailoring wage levels to different circumstances—particularly with respect to the younger segment of the labor force—would be advisable.

Mr. O'Loghlin, thanking his colleagues for their interest, noted that he would convey their comments to his authorities. The decision regarding the appropriate exchange rate at which Ireland should enter into EMU was not Ireland's alone; that issue would be addressed in another forum.

The authorities had been reducing state ownership in the economy, Mr. O'Loghlin continued, and the so-called commercial state sector currently accounted for roughly 5 percent of total Irish employment. The key question was whether public entities imposed undue costs on the rest of the economy through inefficiencies. He assumed that such inefficiencies existed in Ireland, but not to a great degree. Although the authorities had not expressed a clearly stated commitment to privatization, they were likely to continue to divest in response to economic reality and political pragmatism.

Replacement ratios had been declining, as illustrated in the background paper, Mr. O'Loghlin noted. The link between unemployment payments and the number of children in an unemployed person's family had been a major problem. The real value of those child additions was being reduced, and the family income supplement was being enhanced to offset the disincentive for parents of large families to work. He noted, as well, that Ireland had a rather low rate of basic social welfare unemployment benefits, compared with most of its EEC neighbors.

Ireland had maintained a procyclical economic policy, Mr. O'Loghlin considered, although not to as great an extent as suggested by some of the graphics. Over the past two or three years of sustained strong growth, for example, the authorities had increased spending on liquidations of future liabilities—pension liabilities in particular—which made the deficit appear worse than it actually was, and discouraged public demand for further spending or tax reductions that would be inconsistent with long-run objectives. The structural deficit had been reduced by roughly ½ of 1 percent over the past three years as a result of those types of unusual expenditures.

As the staff had mentioned, no evidence existed that the construction boom was fueling price pressures in the services component of the consumer price index or higher personal consumption, Mr. O'Loghlin remarked. In other words, the general price level had not risen in response to either the high economic growth or the pickup in housing prices. The authorities would continue to monitor that situation closely, however.

With respect to Mr. Andersen's suggestion that increasing taxation of enterprises would reduce the element of tax competition by Ireland, Mr. O'Loghlin noted that—based on 1992 data reported in a U.S. publication—returns to U.S. investors doing business in Ireland were enhanced by the competitive level of Irish wages. If Denmark had obtained Irish wage levels in 1992, for example, the rate of return on U.S. investment in that country would have been substantially above that of U.S. investment in Ireland.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended Ireland's impressive economic performance, marked by rapid growth and job creation, declining unemployment, and low inflation. Ireland had made welcome progress in raising living standards and appeared well positioned to be among the first members of the euro area. Directors considered that Ireland's strategy of macroeconomic stability, outward orientation, and social consensus deserved much credit for those achievements. The policy challenge was to sustain those achievements into the medium term.
>
> Directors were of the view that continued growth at the pace of the past few years carried risks of overheating. They encouraged the authorities to be vigilant for signs of emerging strains, with particular attention to the tightening labor and housing markets. They, therefore, welcomed the authorities' readiness to tighten macroeconomic policies as needed.
>
> Directors pointed to the policy challenges that would be associated with Ireland's adoption of the euro. First, the prospective loss of monetary independence would add to the demands on fiscal policy. Second, further progress in structural reforms and strengthening incentives was required to bolster the economy's capacity to handle shocks. Directors noted that the current period of strong economic performance offered an ideal opportunity for actions in that regard.
>
> Monetary policy had delivered impressively low inflation during a sustained period of rapid economic growth. Directors noted that the implementation of monetary policy in recent months had been complicated by the Irish pound's strength in the ERM and by market expectations that Irish interest rates would converge downward by the start of EMU. They agreed that, given the economy's robust growth, the central bank should not seek to hasten that convergence process, and that the recent policy tightening in response to downward pressure on the Irish pound had been appropriate.
>
> Directors commended Ireland's long track record of low fiscal deficits and a sharply declining debt ratio. However, Directors expressed concern about the procyclical stance of fiscal policy in the current year, owing partly to

the front-loaded tax cuts in the budget. They thought it would be desirable to tighten fiscal policy, focusing on expenditure restraint particularly restraint on public sector pay. They noted that renewed slippages from announced intentions to limit the growth of current spending would reduce the scope for tax reform and weaken the credibility of fiscal policy.

Directors welcomed the adoption of a medium-term framework with the 1997 budget. However, they considered that more ambitious fiscal objectives were warranted by the cyclical position and the increasing constraints on monetary policy, the provisions of the Stability and Growth Pact, and the prospect of lower EU transfers in the medium term. Directors suggested that it would be desirable to aim, at a minimum, at fiscal balance by 1999 and to orient the 1998 budget accordingly.

Directors welcomed the further progress in narrowing the gap between the standard and 10 percent corporate tax rates, and encouraged the authorities to move to a unified rate.

Directors supported the increased emphasis on an integrated approach to strengthening work incentives in the reform of the labor market. On the tax side, priority should be given to reducing the high marginal tax rates faced by those leaving unemployment for entry-level jobs. Benefit policies should ensure that work incentives were improved by raising payments to the unemployed by less than wages, and by steps to diminish the differential between child benefits for the unemployed and those at work. Directors also emphasized the importance of measures designed to prevent young school leavers from sinking into long-term unemployment. Regarding the authorities' intention to introduce a national minimum wage, it was noted that minimum wages should be set consistent with the productivity of lower-skilled labor, so as not to affect adversely the reentry of the long-term unemployed, or the entry of less-qualified young people, into the labor market.

Directors stressed the importance of continued wage moderation embodied in the terms of the new centralized pay agreement to guard against price pressures and preserve employment prospects. They underscored that, in order to avoid possible loss of future fiscal policy flexibility, the associated tax and spending concessions should be conditional on realization of the growth assumptions underpinning the agreement.

Directors welcomed the strengthening of the Competition Authority and encouraged rigorous scrutiny of restrictive practices. They also encouraged a more active privatization policy.

Directors observed that rapid credit growth, rising asset prices, and competitive pressures in the financial sector posed challenges for supervision of credit institutions. Continued vigilance was warranted to ensure that those institutions remained adequately protected against adverse shocks.

Directors commended the authorities for the increase in official development assistance.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/66 (6/30/97) and EBM/97/67 (7/2/97).

6. KENYA—ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT—EXTENSION

The commitment period of the first annual arrangement for Kenya under the Enhanced Structural Adjustment Facility (EBS/96/62, Sup. 1) is extended to July 31, 1997. (EBS/97/118, 6/27/97)

Decision No. 11535-(97/67), adopted
June 30, 1997

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/107 (6/27/97), by Advisors to Executive Directors as set forth in EBAM/97/107 (6/27/97), and by an Assistant to Executive Director as set forth in EBAM/97/105 (6/25/97) is approved.

APPROVAL: February 2, 1998

REINHARD H. MUNZBERG
Secretary