March 5, 1998
Approval: 3/12/98

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/89

10:00 a.m., August 29, 1997

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
M.-A. Autheman	A. Fayolle
	E. Jourcin, Temporary
T.A. Bernes	
B. Esdar	W.-D. Donecker
	N. Coumbis
	L. Pinzani, Temporary
D.Z. Guti	
D. Kaeser	D. Gotz-Kozierkiewicz
A. Kafka	
W. Kiekens	J. Prader
	N. Goffinet, Temporary
	B.S. Newman
A. Mirakhor	M. Daïri
A.V. Mozhin	A. Vernikov
	J. Shields
A.S. Shaalan	
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	
	O. Kwon
	M.A. Cilento, Temporary
J.J. Toribio	E. Rodríguez, Temporary
J. de Beaufort Wijnholds	
K. Yao	A.R. Ismael, Temporary
	H. Ono
	D. Fujii, Temporary
Zamani, A.G.	S. Joyosumarto
Zhang Z.	Han M.
	N. Eyzaguirre
	D. Merino, Temporary

R.H. Munzberg, Secretary
A. Mountford, Acting Secretary
S.W. Tenney, Assistant
G.N. Walton, Assistant

Also Present

Government of Sudan: S.M. Hassan, State Minister of Finance; E.F.A. Siddiq, Director General of the Directorate of External Finance and Economic Cooperation; A.E.K. Osman, Deputy Governor of the Bank of Sudan; O.I. El Tahir. Embassy of Sudan: M. Salih. IBRD: O.A. Meesook, Africa Regional Office. African Department: A. Basu, Deputy Director; P. Dhonte, Deputy Director. Asia and Pacific Department: T.A. Bayoumi, C.V.A. Collyns. European I Department: J.R. Artus, Deputy Director; H.M. Flickenschild, D.C. McDonald. External Relations Department: S.J. Anjaria, Director. Fiscal Affairs Department: G.F. Kopits, P.R. Rado. Legal Department: W.E. Holder, Deputy General Counsel; L.E. Nordgaard. Middle Eastern Department: M.A. El-Erian, Deputy Director; V. Sundararajan, Deputy Director; R.E. Daumont, E. Maciejewski, K. Nashashibi, G. Shabsigh, V. Treichel, L.M. Valdivieso. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; S.B. Creane, M. Fisher, J. Lin, C. Puckahtikom. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; J. Aziz, F. Caramazza, M. De Broeck, P.R. De Masi, S.J.A. Gorne, G. Hacche, K. Krajnyak, R. Ramaswamy, T.M. Sloek, A.J. Tweedie. Secretary's Department: W.S. Tseng, Deputy Secretary; P. Gotur, B.R. Hughes. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; W.J. Byrne, J.C. Corr, Z. Farhadian-Lorie, Y.-F. Lum, H. Treichel, M.A. Wattleworth. Western Hemisphere Department: C.M. Loser, Director; M. Leidy. Office in Europe: C. Brachet, Director. Office of the Managing Director: J.A. Quick, Personal Assistant, B.V. Christensen, J.A. Clément. Advisors to Executive Directors: P.A. Akatu, M. Askari-Rankouhi, R.F. Cippa, J.A. Costa, S.S. Farid, P.M. Fremann, A. Levy, M.F. Melhem, H. Mori, Y. Patel, M. Sobel. Assistants to Executive Directors: W.F. Abdelati, J.G. Borpujari, P.I. Botoucharov, M.A. Brooke, J. Chelsky, H.W. Cocker, A.L. Coronel, D.A.A. Daco, M.H. Elhage, W.K. Gruber, R.J. Heinbuecher, Huang X., K. Lai, M. Kell, A. Lushin, M.Z. Maatan, S.D. Melese-d'Hospital, F. Mercusa, I. Moon, M. Nemli, L. Palei, A.R. Palmason, H. Paris, J.L. Pascual, T. Presečan, S. Rouai, J. Salleh, M. Vismantas, Zubir bin Abdullah.

1. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from Executive Board Meeting 97/88 (8/27/97) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/97/139, 8/4/97; and Cor. 1, 8/19/97). They also had before them a statistical appendix (EBS/97/140, 8/4/97; and Cor. 1, 8/19/97), boxes and annexes providing supplementary material (EBS/97/141, 8/5/97; and Cor. 1, 8/19/97), a background paper on world economic and market developments (EBD/97/99, 8/22/97), and a report on foreign exchange and financial markets in July 1997 (EBD/97/97, 8/20/97).

The Economic Counsellor and Director of the Research Department made the following statement:

> I will begin with some comments and reactions, mainly to Directors' remarks about various issues related to the World Economic Outlook. The staff representatives of the Research Department will then follow up on some of those issues as well as a number of specific points dealing with the World Economic Outlook exercise. I will then comment on the issues related to Europe and EMU. I will return at the end to discuss somewhat further the question of exchange rate policies, exchange rate regimes, and related questions, which are obviously a focus of concern in the light of recent events, which continue to be quite turbulent, in east Asian financial markets and more broadly in financial markets around the world.
>
> The comments put forward by Mr. Mirakhor on the World Economic Outlook exercise were very interesting. When I was at the Council of Economic Advisors and we needed to communicate with the President, whose attention was sometimes difficult to grasp and hold on to, we always tried to find some movie analogy that would capture his attention. From that perspective, I would summarize Mr. Mirakhor's intervention as: "never underestimate the power of the dark side." The staff would not wish to underestimate it either.
>
> In that regard, I wanted to begin, somewhat unusually, on a bit of a personal note. A year ago at this time I was visiting the cardiac care unit at the Washington Hospital Center. That vacation was actually occasioned by a meeting of the Interim Committee some months earlier, at which I was sitting next to a colleague who had a rather serious case of the flu, which, as it turned out, got passed on to me and developed adversely. This condition is described almost exactly by the Mayo Clinic heart book:
>
>> "Charles is a 42-year-old commercial artist who recalls missing two days of work four months ago because of a bad cold with a runny nose, sore throat, and cough. Although these symptoms subsided, he never felt back to normal because he tended to be tired all the time. Six weeks ago, he felt distinctly short-winded during a softball game at a company picnic. He stopped playing early so he could sit down and catch his breath. Since then, he had noted shortness of breath when climbing one or two flights of stairs. One week ago, he began waking up in the middle of

the night feeling breathless, which he found he could minimize by propping himself up on a few pillows. For the past two days, his ankles had been conspicuously swollen. Now he has been brought to the emergency room because he awoke gasping after an after-dinner nap. The doctor told him and his wife that his lungs were filled with fluid and his heart was enlarged. He was given an intravenous injection and diuretics and admitted to the hospital. He was diagnosed with dilative cardiomyopathy."

That was my diagnosis, at the level of category 4. How serious is that? There is no category 5. The Mayo Clinic heart book later concludes:

> "Unfortunately, once there are overt signs of heart failure in people with dilative cardiomyopathy, up to 50 percent die within a year and more than 75 percent die within five years. However, research into heart failure has shown that treatment can affect the outcome. Indeed, treatment methods are becoming increasingly effective at controlling the symptoms and extending life, including carefully tailoring medications and appropriate use of heart transplantation."

Although this was a rather serious episode, my doctor recently characterized my recovery as miraculous. This experience shows that even when days are dark there can be an upside. During my six years working at the Fund my view on this philosophy has, if anything, firmed.

As Mr. Mirakhor correctly pointed out, there clearly is a downside to the projections on the world economic outlook, and the risks of a correction in asset markets and the economic consequences of that are clearly one of the risks that is a cause for concern. The staff papers on the world economic outlook are relatively forthcoming on those risks. We are not, however, in a circumstance of worldwide deflation; nor are we likely to fall into one. Indeed, by any historical standard, we have been for the past 50 years—and are likely to continue for the foreseeable future—living in what would ordinarily be characterized as an inflationary environment.

When the pound sterling was established in 1299, its parity was fixed to silver at 12 ounces to the pound, it began to depreciate not long afterward. By the mid-1930s, it had in fact lost two thirds of its value over 6⅓ centuries. That is a compound average annual inflation rate of 1/10 of 1 percent per year. Since then, prices in the United Kingdom have gone up by a factor of eight. In the current environment of low inflation, the industrial countries will likely sustain inflation rates that average 3 percent or less. Looking forward over the next decades, it will still be an inflationary environment by historical standards. Monetary policy authorities clearly possess the capacity and the wisdom to avert any cumulative downturn in prices that would represent a return to the circumstances that we saw on the last occasion on a worldwide basis in the 1930s.

The other issues with respect to the forecast focused primarily on concerns about the situation in east Asia, among the developing countries, and, among the industrial countries, about the prospects and risks for Japan. The staff broadly shares the views of Executive Directors that those are the primary areas of either risk or uncertainty. It is clear, in light of the events of the past few days, that the baseline forecast for Southeast Asia is now unreasonably optimistic; that a realistic downward revision would probably knock back those forecasts, for 1998—because 1997 is now to a large extent already in the bag on a year-over-year basis—for real GDP growth for some countries by 2–3 percentage points. I would not recommend adjusting the forecast by that amount, because the signaling value of such a negative message at this stage would not be helpful, but we are clearly going to need to indicate in the World Economic Outlook a downward revision of the forecast either numerically or in the text along with a fairly forceful statement acknowledging that recent events have created very substantial risks on the downside.

For Japan, the situation is different. As a few Directors have noted, the staff forecast is more optimistic than the consensus forecast—not by very much for 1997, but the Fund's estimates for growth are nearly 1 percentage point higher than the consensus forecast would suggest, even with the recent slight downward revision for 1998. With respect to 1997, again much of the year has already passed. If we assume that growth in the second quarter was negative, as seems very likely to be the case, we could, for example, say it dropped 4 percent at an annual rate, and if the rest of the year were flat—that is, zero growth in the remaining two quarters—Japan would turn in a real GDP growth performance of 1.7 percent for 1997. I think it would be too pessimistic to assume that the remainder of the year will be flat. So the staff forecast for growth of 2.1 percent of GDP for 1997 is reasonable.

The real issue is the expected outturn for 1998. Our estimate for growth in 1998 is on the high side—not in terms of the potential outcome, but in terms of the weight of the distribution that lies above an outcome of 2.7 percent, year-over-year, versus the weight that lies below that likely outcome. At this stage, a forecast of real GDP growth of about 2¼ percent year-over-year for Japan would be closer to the center of the distribution of reasonable outcomes.

In this context, Mr. Sivaraman asked a more general question about the effect of fiscal consolidation and the contrast between the May 1997 *World Economic Outlook* and the staff papers for the current World Economic Outlook exercise. In that respect, it would be useful to clarify the issues in the precise context of Japan. The view, strongly supported by rigorous analysis of available statistical evidence, is that the tendency is, in the short term, for fiscal consolidation to have a negative effect on output. A 1 percent structural adjustment of the budget position would tend to have about a minus 1 percent effect—for some countries, a little bit bigger; for some others maybe a little bit smaller—on GDP growth over a year or so. That is the ceteris paribus effect.

In Japan, in 1996, with the assistance of an easy monetary policy, correction of the exchange rate, and a boost from fiscal policy, which was then expansionary, the rate of growth was 3.7 percent year-over-year. If fiscal policy had been neutral for 1997, I would have expected, even without any fiscal boost, that Japan would have matched 3.7 percent growth this year. Once you get the economy recovering and it has forward momentum, it will grow faster than potential. That has been the common experience throughout the postwar period. A quite substantial fiscal consolidation in 1997, estimated as a structural adjustment in the budget position of about 2 percent of GDP, was expected to slow that outcome from what would otherwise have been the case, i.e., from about 3.7 percent down to about 2.25 percent. So the partial effect is negative. If you try to do too much fiscal consolidation all at once and the economy is otherwise weak, you can create a recession. But there have been relatively few instances in the postwar period in which the magnitude of fiscal consolidation undertaken has been sufficiently great or sufficiently concentrated that it alone would have generated a recession, even though its partial effect does tend to slow domestic demand growth. That is what we are seeing now in Japan. One of the reasons for optimism about the recovery of growth is that a repeat of the 2 percent structural fiscal consolidation is not expected in 1998. The Japanese authorities have indicated that they might consider consolidation measures amounting to about ½ of 1 percent of GDP. If we see a pickup in domestic demand growth before the end of 1997, we would be wise to proceed with our current projections for 1998. If economic activity remains very weak for the remainder of this year, the Japanese authorities will need to consider very seriously what, if any, additional fiscal consolidation measures should be programmed for 1998.

While I would hold that question open, I would not consider any temporary stimulus measures at this stage of the game. We need to wait and see what the outcome looks like, and then make a judgment about what is a prudent fiscal policy for 1998. While we expect that some further consolidation will be appropriate in 1998, judgments on the magnitude should be left for consideration at a later stage.

The other factor that is negative, and more so for Japan than for other industrial countries, is the potential spillover effects that could be realized from the apparent slowdown in east Asia. If there is some slowing of export growth to that region, it would tend to cap the tendency of the Japanese current account surplus to rise. For that reason, the staff should be a little more conservative in its growth forecast for Japan now than would have been the case two or three months ago, when a forecast of growth of between 2.5 percent and 3 percent would have been reasonable. I would also be a little more negative, because domestic demand would be a little bit weaker and because exports would be weaker.

The staff representative from the Research Department noted that the staff papers on the World Economic Outlook exercise would be revised to incorporate the suggestions made by Directors in a number of areas. For example, the staff papers would clearly indicate the need for countries to move toward full compliance with the Basle Committee's core principles, an omission referred to by Mr. Shields, Ms. Srejber, and Mr. Wijnholds.

The staff would also consider making further revisions to the projections in light of more recent developments and data, the staff representative said. Those revisions would include changes in the projections for the United States following the recent upward revision of data on second-quarter growth. The staff would also reexamine the projections for Italy, in light of the strong second-quarter data that had recently been received in the Fund. However, the staff's current projections for Italy were only slightly below the official forecasts.

There might also be further revisions to the projections for some of the Asian countries, the staff representative stated. The projections for Korea, in particular, which had been questioned by Mr. Kwon and Ms. Lissakers, were being reviewed by the staff, and some downward revision seemed likely.

The staff would also review the references to the yen in the main staff paper, which stated that the depreciation in the first four months of 1997 appeared to have taken the yen to a level that was likely to bring about an unjustified widening of Japan's current account surplus and that the subsequent moderate strengthening of the yen seemed to have been appropriate, the staff representative commented. However, the staff did not consider that either of those statements was likely to lead to undesirable reactions in the markets or that they could send a misleading signal about the yen's equilibrium exchange rate. Those statements did not differ from the statements that had been made about a number of other exchange rate movements.

On the developing countries, the staff recognized the extent to which Africa's improved growth performance in 1995/96 was due to one-off factors, particularly improved weather, the staff representative continued. The downward revision in the staff projections for growth in Africa in 1997 clearly showed how sensitive African countries were to weather developments. In 1995 and 1996, weather conditions had had a positive influence on growth in a number of countries, but the staff did not have any measure of its impact on the entire region. Nevertheless, there had been a substantial improvement in the underlying growth performance of many African countries and the current projections reflected to a large extent policy improvements, including in trade and exchange liberalization, more realistic exchange rate policies in a number of countries, and improvements in macroeconomic discipline.

Underlying growth in Africa, particularly sub-Saharan Africa, had strengthened steadily over the past five years, and since 1994 it has been substantially higher than in the preceding decade-and-a-half, the staff representative went on. In sub-Saharan Africa, 1997 was expected to be the third consecutive year of growth above 3.5 percent—that upward trend represented the first in two decades. The staff would attempt to clarify in the text of the World Economic Outlook the fact that the staff projections on the outlook for Africa had taken into account the prospects for external financial flows and debt obligations.

It would not be easy to provide a categorical answer to the question about how recent movements in the exchange rates among the major currencies had affected developing countries' export prospects, the staff representative considered. For any particular developing country, the answer would depend on how its effective exchange rate, international competitiveness, and the demand in its trading partners had been affected by the exchange rate changes. Countries pegging to the U.S. dollar had tended to lose competitiveness, while countries pegging to European countries had tended to gain competitiveness. It should be borne in mind, of course, that the implications of recent exchange rate changes would also depend on how durable those changes were. As the staff papers indicated, there were reasons to believe that some recent currency movements would be reversed, at least to some extend, as cyclical conditions evolved.

With regard to the staff's analysis of exchange rate arrangements and economic performance, Mr. Shaalan had asked whether the findings for the period under investigation, 1975 to 1996, fully reflected the influence of financial market globalization, which had become much stronger in recent years, the staff representative recalled. As far as the macroeconomic characteristics of exchange rate regimes were concerned, the staff had not found any significant change in the relationship between exchange rate arrangements and either growth or inflation in the most recent years. Nevertheless, globalization had had the important consequence of making the maintenance of pegged but adjustable exchange rate regimes more demanding, especially in cases where the underlying policies were not supportive. That had no doubt contributed to the trend toward greater flexibility.

The points made by Mr. Mozhin on the classification of transition countries according to monetary regime and exchange rate arrangement in Table 20 were well taken, the staff representative commented, especially as it did not distinguish currency board arrangements, targeted exchange rate regimes, and managed floating exchange rate arrangements with sufficient clarity. That table would be revised accordingly.

The staff papers certainly did not intend to downplay the importance of privatization in the transition economies, the staff representative stated. The impression that they had done so might reflect the particular focus of the World Economic Outlook on monetary policy, exchange rate arrangements, and financial systems. The May 1997 *World Economic Outlook* had devoted considerable attention to privatization. In the context of a study of fiscal policy, the staff had examined the transformation of the role of the state. Privatization was clearly a central element of the transition process, and the staff would no doubt return to that issue in future World Economic Outlook exercises.

In the context of privatization, Mr. Mozhin had questioned the argument linking privatization policies with structural weaknesses in former state enterprises in the discussion of growth in the Russian Federation and Ukraine, the staff representative recalled. Case studies for both Central and Eastern Europe and Russia indicated that strong corporate governance was essential in bringing about an in-depth restructuring of former state-owned enterprises. Such corporate governance, in turn, had required relatively concentrated ownership and an ability on the part of shareholders to effectively exercise their voting and control rights. The privatization programs actually implemented in Russia and Ukraine, however, had not always been very effective in strengthening governance, as many firms had ended up with dispersed and insider-dominated share ownership.

At the same time, however, evidence on Central and Eastern European countries indicated that privatizing early on in the transition process had promoted restructuring in those cases, the method of privatization had been less important, the staff representative continued. Mass privatization, for instance, had led to concentrated ownership in the Czech Republic and in the Slovak Republic. The argument that privatization did little to improve corporate governance in Russia and Ukraine specifically should, therefore, not be interpreted as a general statement on the benefits of privatization or on the merits of certain privatization methods. The staff would review the text of the World Economic Outlook to avoid any implication to that effect.

As Mr. Mozhin had indicated, there were uncertainties attached to real GDP data in the transition countries, the staff representative went on. Thus, caution was needed in view of the various measurement problems, which had been discussed in previous editions of the *World Economic Outlook.* The staff was mindful of the need to look at other indicators, including monetary and fiscal data. However, real GDP data provided the best single estimate of economic activity and growth. Extensive technical assistance from the Fund and other international agencies had led to significant improvements in the quality of real sector statistics in the economies in transition. In addition, the statistical committee of the Commonwealth of Independent States had made substantial methodological efforts to guarantee comparability of data across its members more specifically.

The classifications of countries used in the *World Economic Outlook* were kept under constant review, the staff representative stated. Clearly the classification "transition economies" had built-in obsolescence, to the extent that those countries would not be in transition forever or even, it was hoped, for long. At some stage there would clearly be a need to reclassify them. However, for the time being, it was helpful to retain that country grouping, even though there were important differences among the countries in that group, just as there were differences among the various advanced economies and the various developing economies. For the time being, there appeared to be enough similarity among the countries categorized as "transition economies," in terms of their structural characteristics and policy challenges, for that grouping to be helpful for analytical purposes.

The Deputy Director of the Research Department said that Mr. Mirakhor and Mr. Wijnholds were correct to point out that the introduction of a single common currency in Europe could be considered to constitute the "ultimate peg." Considered in the light of the trend toward greater flexibility in exchange rate arrangements, the advent of economic and monetary union and the adoption of a common currency was not that much of a paradox as it might first appear. The move toward EMU could be seen as a response to the difficulties and challenges associated with maintaining fixed but adjustable exchange rate pegs in a world of integrated capital markets, especially under circumstances where countries were subject to a wide variety of asymmetric disturbances and where they experienced significant cyclical divergences and, consequently, had different policy requirements.

With respect to the uncertainties about EMU, there were counterbalancing factors to be considered, the Deputy Director stated. The strong convergence of macroeconomic policies and performances provided good reason to believe that the move to EMU would take place on schedule. That belief was reflected in current market expectations and in the staff's baseline scenario. However, it would be premature to regard EMU as a fait accompli. There were a number of political uncertainties, as well as questions, about the business cycle.

Certainly, conditions for recovery in continental Europe had improved significantly over the past year, the Deputy Director considered. Competitiveness and business confidence had strengthened and exports were growing solidly. But domestic demand had remained quite hesitant, unemployment had been rising further, and consumer confidence was weak. There was clearly some upside potential to the staff forecast, but there were also downside risks. Deviations from the staff forecast would have a substantial impact on budget outcomes. On average for Europe, a 1 percentage point variation in the growth rate of GDP could affect budget positions by as much as 0.6 percent of GDP. In many countries, the response coefficient would be even higher. Although countries were committed, in theory, to meeting the 3 percent budget deficit target, they could not be certain to do so, in practice. For that rea: n, it was important to assess the underlying progress toward macroeconomic cor rgence, which had been more impressive than actual budget deficits seemed to imply.

The staff would agree with Directors on the margins of uncertainty attached to estimates on natural rates of unemployment, potential output, and structural budget deficits, the Deputy Director stated. However, even given the uncertainties, the concept of structural budget balances was an indispensable tool in assessing policy requirements and the degree of effort being made. The structural budget deficit concept made it possible to separate the effects of policy changes from the effects of variations in the economic performance on the budget. Use of that concept might also help to avoid a relaxation of budget consolidation efforts when activity picked up in Europe. Otherwise, budget positions might appear to be stronger than they really were.

In order to further emphasize the strange implications that could arise from considering convergence only in terms of actual budget deficits, it might be useful to consider the following scenario, the Deputy Director suggested. If for 1997 all of the European countries in 1997 were in cyclical positions similar to that of the United States—that is, with actual output perhaps slightly above the level consistent with stable inflation over the medium term; and if their actual budget deficits were in the range of, say, 2.5 percent of GDP, it would be possible to assume that the Maastricht criteria would be met. It would then seem reasonable to proceed with stage 3 of EMU, even though the underlying or cyclically adjusted fiscal imbalances would, in fact, be substantially larger than they would appear to be in the given circumstances. Thus, actual budget balances could be extremely misleading in terms of the degree of underlying convergence that was being achieved.

An important weakness associated with both the actual and the structural budget estimates was that they did not distinguish between various types of budget consolidation efforts, including with respect to either their sustainability or their desirability in terms of their effects on allocative efficiency in the economy, the Deputy Director continued. Unfortunately, in their strong efforts to meet the Maastricht deadline, many governments in Europe had resorted to temporary spending freezes and increases in already high tax burdens, not to mention certain accounting tricks, rather than tackling the root causes of Europe's long-term budgetary problems. In the circumstances, questions could arise as to whether the zeal being demonstrated with respect to meeting the 3 percent budget deficit target had been diverting attention away from the underlying structural problems.

The remaining concerns on the part of the staff about the move to EMU were related not so much to macroeconomic policies or macroeconomic convergence as to the state of labor and product markets, that is, the question of whether the fundamental structural policy requirements were in place, the Deputy Director explained. Structural problems were not mentioned in the Maastricht Treaty, but that did not make them any less important. Needed structural reforms had not yet been put in place in all of the potential EMU members. It was ironic to note that the countries, such as Denmark and the United Kingdom, that seemed to meet the structural policy requirements for monetary union seemed to be reluctant to participate in EMU.

The lack of flexibility in continental Europe's labor markets was particularly worrisome, owing to the risk that structural unemployment would continue to ratchet up and owing to the implications for long-term budgetary sustainability, the Deputy Director added. Given the crucial importance of fundamental labor market reform, the staff's support for EMU was predicated on the assumption that the new policy regime under EMU would promote the necessary labor market reforms; or, in other words, that EMU would become a catalyst for labor market reform. In his opening statement, Mr. Shields had interpreted the staff's insistence on the need for labor market reforms as a judgment that no EMU would be better than EMU without labor market reform. Perhaps that was not the best way to look at the staff's position; labor market reform would be crucial with or without EMU.

With respect to the unemployment problem and the extent to which macroeconomic and structural policies might help alleviate that serious policy challenge, Directors had generally supported the staff analysis and policy recommendations, the Deputy Director recalled. Nevertheless, some speakers had questioned the need to discuss the reasons for Europe's weak performance, especially the role of macroeconomic policies. The staff considered that such an analysis was helpful, both to improve understanding of how the current situation evolved and to highlight that the most important reason for high unemployment rates was the continued need for fundamental labor market reform. The staff's views on labor market reforms were supported by the analysis on the role and contribution of macroeconomic policies.

With respect to Mr. Autheman's comments on whether the staff papers were overly critical about work-sharing arrangements, particularly given the importance of part-time work in the United Kingdom and the Netherlands, it was important to distinguish between part-time work and work sharing—which was often achieved through cuts in working hours—particularly if their use was mandatory, the Deputy Director considered. The creation of part-time jobs in an economy might have the positive result of promoting greater labor market flexibility in response to increased demand and supply, especially for jobs that might previously have been frustrated by labor market regulations. Like part-time jobs, mandatory cuts in working time would influence both the demand and supply of labor, but in a quite different manner. Such cuts would likely have the most positive effects in terms of creating new employment opportunities in the public sector. However, an increase in taxes might be needed to finance the new positions. In the private sector, the employment response to such cuts would depend on their implications for real wage costs and the availability of qualified individuals to replace those who would be working fewer hours. If the skill requirements were not satisfied, enterprises would cut back their levels of production. If hourly wage costs increased, in order to keep income levels constant despite the cut in working hours, enterprises would accelerate the process of job shedding and restructuring. The net result might well be a decline in private sector employment and an increase in structural unemployment. Ultimately, such measures could bring Europe closer to the unfavorable scenario described in Chapter 3 of the main staff paper, with lower levels of income, larger budgetary imbalances, and considerable vulnerability to adverse disturbances.

Mr. Mirakhor commented that it was pleasing to note the recent diagnosis of the Economic Counsellor and Director of the Research Department's health. It was to be hoped that he would be in a position to continue his contributions to the Fund for many years to come.

The many factors underlying a more pessimistic view of world economic prospects should not be dismissed too quickly, Mr. Mirakhor considered. However, it was encouraging to note the staff's view that the risks to the current projections, including the mixture of very hot assets and fairly cold product markets, were not expected to result in worldwide disinflation. He could accept, for the time being, the staff's view that current monetary authorities could deal with that threat.

The data on the U.S. economy showed seven successive months of declining producer prices, Mr. Mirakhor noted. He wondered whether similar periods had occurred in the post-war period or whether there were underlying factors that might help to explain that phenomenon.

He also wondered whether the staff could comment on whether recent events in Southeast Asian markets were expected to have implications for the availability and cost of capital for developing countries, Mr. Mirakhor said.

As to the observation that the European countries were moving toward the adoption of an exchange arrangement that could be seen as a the "ultimate peg," it should be noted that the success of a common currency area was dependent on full wage price flexibility, Mr. Mirakhor considered. As such flexibility did not exist in Europe at the present stage, the EMU could be seen as a fixed exchange rate system.

Mr. Shields recalled that, in his opening statement on the world economic outlook, he had suggested that the long-term forecast in Figure 3 of the main staff paper be limited to the year 2002. The U.K. Treasury had in the past run into difficulties, owing to the misinterpretation of a similar extrapolation. Experience showed that it was safer to confine such longer-term forecasts to data periods, for which projections were reliable. An alternative might be to present the staff's comments on the implications of current policies for growth rates in the text. In that way it would be possible to highlight all of the very hypothetical assumptions that were incorporated in the longer-term forecast. There was a tendency for such assumptions to be overlooked when projected outcomes were presented in chart form.

It was important to note that the estimates on structural fiscal deficits were highly dependent on assumptions about trend output, Mr. Shields noted. Bearing that caveat in mind, data on year-to-year changes in structural deficits were helpful in trying to identify the effects of changes in the business cycle versus structural changes in the economy.

It was his understanding that the Maastricht criteria for budget deficits of 3 percent of GDP was to been as a maximum limit, Mr. Shields said. That target was to ensure that fiscal deficits in Europe would be consistent with the level of slack in the U.K. and U.S. economies. A fiscal deficit aimed at convergence would be considerably lower than 3 percent of GDP.

Mr. Esdar considered that one of the main problems with respect to unemployment in Europe was the tendency among labor ministries and labor unions to focus on ways to appropriately share the scarce jobs available, rather than finding ways to create more jobs. Many of the steps that had been taken thus far to solve the unemployment problem in Germany, such as job-sharing arrangements and measures to shorten working hours, had resulted in increases in labor costs and the destruction of existing jobs rather than the creation of new ones. There was really a need for greater focus on schemes aimed at job creation.

While he would not wish to reopen the discussion on the Maastricht criteria and structural fiscal deficits, the concerns of his authorities were similar to those expressed by Mr. Shields, Mr. Esdar said. The Maastricht process encompassed two steps. In the first step, countries would examine whether the fiscal deficit target of no more than 3 percent of GDP had been met. In the second step, they would consider whether underlying policies were sustainable. The suggestion that there might be some trade-off between strict adherence to the Maastricht criteria and progress on structural reform was a cause for concern. In the view of his authorities, it was not a matter of trading off one criterion for another, but a matter of proper sequencing.

The longer-term forecast presented in Figure 3 of the main staff paper was helpful, Mr. Esdar stated. That forecast provided an opportunity for countries to consider carefully their current positions as well as the measures needed to improve competitiveness for the future. It was to be hoped that those forecasts would generate policies discussions within member countries.

Mr. Eyzaguirre commented that the points raised by Mr. Mirakhor on price developments in asset markets were interesting. Indeed, the increase in asset market prices and the decline in producer prices represented an interesting phenomenon. However, it was not necessarily a symptom of possible risks to the projections on the world economic outlook. For example, a strong upward trend in savings rates would place upward pressures on prices in capital markets and less pressure on product markets. Similarly, advances in technology could explain the increase in asset prices combined with the decrease in producer prices.

Mr. Ono noted that the prospects for a self-sustained recovery in Japan in 1998 were good. As Mr. Yoshimura had indicated at the previous discussion (EBM/97/88, 8/27/97), the current decline in domestic demand caused by the recent tax increases made the outlook for 1998 less certain. In that respect, some Directors had focused on the downside risks to the Japanese outlook for the current discussion, while others had been more optimistic, pointing to the underlying soundness of the Japanese economy. Taken together, Directors' comments for the current discussion provided a well-balanced, if neutral, assessment of Japanese prospects over the shorter term. Clearly, there was a need to await the further data that would become available at the end of 1997 before making concrete judgments.

The staff papers for the current discussion indicated that, based on the underlying economic fundamentals of the Japanese economy, the recent moderate strengthening of the yen's exchange rate seemed appropriate, Mr. Ono recalled. His authorities would prefer that the Fund refrain from making public statements about the appropriateness, or the desirability, of changes in Japan's exchange rate. Although his authorities would not insist on asking the staff to make the necessary revisions in the World Economic Outlook, some editorial modification toward that end would be in order and appreciated.

Mr. Autheman considered that, while the staff's assessment that it might not be appropriate to indicate too strongly the need for a downward revision in the projections for the Asian economies seemed wise at first glance, there was reason to question that judgment. In 1995, the Fund had included very optimistic growth projections for some Latin American counties in the *World Economic Outlook*, only to revise those projections significantly downward later. In the light of recent developments in the Asian markets, any failure on the part of the Fund to acknowledge a change in the forecasts would risk credibility. In the circumstances, it might be wiser to clearly acknowledge the fact that the return to stability in the Asian economies would rely on a substantial slowdown in growth over the period immediately ahead, although a recovery could be expected to materialize once the initial shocks of the market crisis were overcome.

Mr. Sivaraman said that, although he agreed with Mr. Autheman that ignoring the changes in the prospects of the Southeast Asian economies would not be realistic, a move by the Fund to significantly revise the growth projections downward could incite further repercussions in the markets.

With respect to the pervasiveness of labor market rigidities and their impact on reform efforts, the government of India had recently undertaken measures to encourage the establishment of a large number of banks in the private sector in an effort to deepen the banking sector and expand banking sector activities into rural areas, Mr. Sivaraman noted. Over the past two days, the entire banking sector in India had been paralyzed, owing to a strike by the labor unions in protest of the extension of banking activities in the private sector. While it was to be hoped that the government of India would be able to overcome that problem, it served as an example of the pressures labor unions could bring to bear on reform efforts. The problems faced by the European countries in overcoming such labor market rigidities were likely to be as severe as, if not worse than, those faced by India.

The Chairman stated that recent events in India served as an example of the kinds of insider-outsider disputes that were taking place in labor markets all over the world.

Mr. Newman commented that it would clearly be a mistake to attempt to shade the staff's forecasts for the Southeast Asian economies in an attempt to manipulate market behavior. To do so would not only set a dangerous precedent for preventing future crises, it would also destroy the Fund's credibility.

He wondered whether the staff could comment further on possible changes in productivity in the United States, Mr. Newman said.

The Economic Counsellor stated that he agreed with Mr. Autheman and Mr. Newman on the need to indicate, either through revisions in the numerical forecasts or in the text of the World Economic Outlook, that the growth performance of the Southeast Asian economies for 1998 would likely be less positive than initially expected. Any failure to do so would clearly risk the Fund's credibility. In that respect, the staff would revise the text and the tables related to the Southeast Asian economies to make it clear that, although there was considerable uncertainty at the present stage, a downward revision in the forecasts was needed. Although it might be possible to justify downward revisions in the growth forecasts of 2–3 percentage points in some cases, the staff would prefer a more cautious approach. It would make moderate modifications to the forecasts, but include a clear statement that the current projections did not fully reflect the most recent financial market developments.

With respect to the concerns raised by Mr. Mirakhor about the overall positive tone of the World Economic Outlook, the staff's intention was not to ignore the downside risks to the current forecasts, the Economic Counsellor said. However, in the current circumstances, it would be difficult to try to pinpoint certain countries as being subject to significant risks.

The Chairman asked whether, in revising downward the growth projections for Southeast Asian economies, the staff would indicate that the expected slowdown in those economies could make a useful contribution to sustained higher rates of growth in the future.

The Economic Counsellor responded that markets frequently overreacted to events such as the recent market turbulence in Thailand, which was spreading to other areas of the

Asian region. While those events would clearly have consequences in terms of undermining growth in the affected economies over the near term, it should be borne in mind that the Asian economies were strong in terms of their past economic performance and their strong underlying fundamentals. As experience in Argentina and Mexico showed, such sharp falls in near-term growth were sometimes followed by quick and sustained recoveries.

The market pessimism reflected in the most recent developments in Southeast Asia was probably exaggerated, the Economic Counsellor considered. In cases such as that of Thailand, it was the job of the international community to make clear that the markets had been overly enthusiastic in supplying the initial flows of capital to those countries at the outset; that had helped give rise to the recent crisis; and that markets were likely overreacting in the current rush to reverse the capital inflows of the past. Recent market developments in Southeast Asia brought to mind the words of Franklin Roosevelt in the wake of the Great Depression of 1933 that, " . . . this is preeminently a time to speak the truth, the plain truth simply and boldly, so first let me assert my firm belief that we have nothing to fear but fear itself, nameless, unreasoning, unjustified terror which paralyzes all attempts to convert retreat into advance." Of course, the terror in 1933 was not completely unjustified. The growth of nominal GDP had fallen by 40 percent and overreactions had taken price stocks way up in an environment of falling commodity prices. Another overreaction had then caused market confidence to collapse, thereby contributing to the depth of the economic difficulties that followed. The current situation of Southeast Asia was different from that prevailing in the United States in 1933. However, there were similarities in the way markets had overreacted to developments as they unfolded. In the circumstances, the Fund should try to help ameliorate the markets' tendency to overreact. The revisions to the staff forecasts should avoid contributing to the current bout of excessive fear, but they should note that the outcome with respect to near-term growth would be weaker than the initial forecasts had suggested.

In response to the comments put forward by Mr. Shields on the longer-term forecast illustrated in Figure 3 of the main staff paper, the staff could shorten the period of that forecast to end in 2005, the Economic Counsellor stated.

Mr. Wijnholds said that he could support the compromise suggested by the staff on the period of the longer-term forecast illustrated in Figure 3 of the main staff paper. Perhaps the lines in that Figure could be changed to illustrate the portion of the forecast that was based on actual data and the portion that was based that was on an extrapolation of the current policies.

The Economic Counsellor noted that, while Mr. Mirakhor was correct to point out that the producer price index in the United States had declined over the past seven months, it should be noted that the decrease each month had not been large. In 1986, when oil prices had collapsed, the United States had experienced a sharp drop in the producer price index. At that time, Germany and Japan had also experienced small declines in their consumer price indexes. The United States had experienced a general decline in both consumer and producer prices over an even more extended period in 1954. Indeed, following the end of the Korean War, there had been a sharp drop in commodity prices worldwide, as well as a downturn in the U.S. consumer price index.

The current weakness in worldwide commodity prices reflected, at least in part, the increasing intellectual and human capital component in world GDP, the Economic Counsellor considered. The ratio of intellectual and human capital to world GDP had risen fairly consistently over recent years. The increase in that ratio was partly related to the persistent decline in the prices of physical commodities. In addition, if finished goods were included in the producer price index, the recent declines in the prices of computer products and electronic goods would also be seen to contribute to the overall decline in the producer price index. However, recent developments in the prices of physical commodities and in the producer price index should not be seen as an indication that worldwide disinflation was likely.

The most recent data on productivity growth in the United States suggested that there might be some under measurement of GDP, the Economic Counsellor noted. The statistical techniques used to measure GDP might not be picking up some part of domestic product. While the data on product and incomes taken from the Internal Revenue Service, and were based on developments in government revenues, the income side had been growing more rapidly than the product side over the most recent period. Therefore, the product of unincorporated businesses, such as those run out of homes, might not be fully captured in the recent GDP data. In that case, the rate of growth in the U.S. economy might be better than currently forecast.

Evidence also suggested that there was an upward bias in the consumer price index, the Economic Counsellor said. That upward bias had been a subject of discussion in the United States since the 1950s, but the most recent data suggested that the magnitude of that bias might have lessened over recent years, owing to improvements in the methodologies used by the Bureau of Labor Statistics in measuring the consumer price index. Thus, the measured rate of inflation might actually have been closer to the underlying cost of living index by 2/10–3/10 of one percentage point on an annual basis over the past few years than it had been in the 1950s.

It was surprising to note that there was no strong evidence of an increase in the consumer price index, the Economic Counsellor considered. Given the size of recent increases in the rate of unemployment and the tightness of the labor market, the current consumer price index data gave rise to questions about the true natural rate of unemployment in the United States. Based on the most recent estimates, the natural rate of unemployment might have decreased, although only time could tell if it would remain at the new lower level on a sustainable basis.

It would not be sensible to tighten the monetary policy stance as soon as the actual unemployment rate fell below the natural rate of unemployment of 6 percent, the Economic Counsellor said. If the economy had the opportunity to grow beyond potential as currently envisaged it would be important to provide sufficient flexibility for it to do so. At the same time, however, it would be important to stand ready to implement the policies needed to avoid a dramatic tightening of monetary conditions later. In that respect, it was worth recalling that the last time the U.S. Federal Reserve had needed to slow inflation, the federal funds rate had been increased abruptly from 6 percent to 10 percent, following the stock market crash of 1987. Experience in other economies, such as Canada, Germany, and the United Kingdom also showed that, once inflation gained a foothold, increases in real short-term interest rates of 5–6 percent had been needed to prevent overheating. Given the current situation of the United States, it would be appropriate and sensible to tighten the federal funds rate somewhat at the present stage in order to prevent the need for more significant tightening later.

In response to the concerns Mr. Ono had expressed about the reference in the staff papers to the exchange rate of the yen, it was important to note that the previous *World Economic Outlook* had concluded that the appreciation of the dollar and the depreciation of the yen that had occurred in early 1997 might not be compatible with the further reduction of external imbalances and, thus, that those currency movements might need to be reversed as cyclical positions became less uneven, the Economic Counsellor commented. At about the same time that the May 1997 *World Economic Outlook* had been published, Japanese officials had expressed concerns about the extent of the depreciation of the yen—to about ¥130 to the dollar—that had taken place. Against that background, the staff papers for the current discussion recognized that the yen had appreciated modestly since the time of the previous *World Economic Outlook*, and that, if the previous exchange rate had been sustained, it might have caused problems for the medium-term evolution of the current account position. Taken in that light, the statement in the current World Economic Outlook, which was in very general terms, was not unlike the statements typically made on the exchange rates not only on the yen and the dollar, but also other currencies.

With respect to the asymmetric movements toward capital account liberalization, Ms. Lissakers, Mr. Shields, and Ms. Srejber were correct to note that there seemed to be a tendency for countries to first liberalize on the side of capital inflows while maintaining some restrictions on capital outflows, the Economic Counsellor stated. That tendency had not been examined at depth, but the staff encouraged countries that faced capital inflow problems to consider liberalizing capital outflows as part of their overall stabilization strategy. Perhaps further consideration of the issues related to asymmetric capital account liberalization would be warranted in the future.

The World Economic Outlook would be revised to take into account the importance of the euro for the countries of Central and Eastern Europe, as suggested by Mr. Kiekens, Mr. Jonáš, and Mr. Wijnholds, the Economic Counsellor continued.

With respect to the choice of an appropriate peg to avoid contagion effects in Southeast Asia, the current difficulties might have been eased somewhat if the Asian currencies had been linked to a basket of the dollar and the yen, the Economic Counsellor commented. However, it was doubtful that all the difficulties encountered by Thailand could have been avoided by that alone.

Flexible exchange rates were not a prerequisite for capital account liberalization, the Economic Counsellor stated. For example, Hong Kong had managed successfully with an open market as far as international capital was concerned and a tightly pegged exchange rate. Thus, there could be no rigid prescription with respect to an ideal exchange rate regime. Nevertheless, a number of developing countries had found it easier to deal with capital inflows under more flexible exchange rate systems.

In circumstances where capital inflows were being used to finance higher levels of domestic spending or current account imbalances, the staff would not necessarily recommend exchange rate appreciation, the Economic Counsellor noted. Rather, the staff would recommend taking a more flexible approach to exchange rates, thereby allowing them both to appreciate and depreciate in response to developments in capital flows. The adoption of such flexibility sent clear signals to investors about the exchange risks associated with capital movements.

Mr. Eyzaguirre observed that, if appreciation was avoided in the face of capital inflows, there was a tendency for current account deficits to widen. However, for some countries, allowing an appreciation of the exchange rate could have adverse implications for inflation.

The Economic Counsellor said that, in such circumstances, it was the policy mix that would determine a country's success in combating problems related to capital inflows. For example, in 1994, when Chile had experienced upward pressures on the exchange rate owing to large inflows of capital, the authorities had widened the fluctuation band to allow the exchange rate to appreciate. However, in taking that approach, the authorities had allowed the exchange rate to appreciate with a clear recognition that it could depreciate again in response to changes in the flows of capital. The authorities had intervened in the market to a modest extent to help facilitate the absorption of inflows. They also firmed fiscal policies and strengthened prudential regulations in the financial sector, particularly with respect to the short-term foreign credit liabilities of the banking system. Thus, in Chile, it was the package of policies—rather than the decision on exchange rate movements—that had addressed the problem related to capital movements.

Mr. Toribio stated that he agreed with the staff that exchange rate flexibility was not a prerequisite for capital account liberalization. However, greater exchange rate flexibility was clearly helpful. Very few governments were ready to acknowledge the fact that if they maintained fixed exchange rates and liberalized capital markets, they would lose independence over their monetary policies.

The Economic Counsellor commented that one of the main messages of the World Economic Outlook was the need to establish clear linkages between the policies and the exchange regimes countries chose to follow. Those linkages had to be sensitive to the environment in which the economy operated. For example, as Mexico traded predominately with the United States, its exchange rate would clearly need to take into account changes in the exchange rate of the dollar, either through the adoption of a peg to the dollar or through the use of a currency basket, in which the dollar was predominant. However, Korea should take into account both the yen and the dollar, given its trade relationships with both Japan and the United States. Thus, in an open economy experiencing large inflows of capital relative to its size, it would be crucial to take into account trade patterns not only in selecting an appropriate exchange rate regime, but also in managing policies within the context of that regime. As Hong Kong had very open capital markets, it would need to conduct its affairs in such a way as to ensure domestic and foreign investors would not react to artificial stimuli with large movements of capital.

In his opening statement, the Economic Counsellor recalled, Mr. Mozhin had indicated that:

> "I doubt it is justifiable to include in the managed floating regime group those countries where the monetary framework is defined as exchange rate targeting. What is different between a conventional fixed exchange rate and exchange rate targeting is just the relative strength of the commitment, which may vary within some range. Actually, whether we like it or not, almost all transition economies regard the exchange rate as a major and primary variable to be controlled, and they view any unanticipated deviation from the prescribed rate as a serious matter."

It was important to note that, while Mr. Mozhin's observations were true for the economies in transition, they were also true for the developing countries as a group, and for the smaller industrial countries, including those with flexible exchange rate regimes, the Economic Counsellor said.

In his opening statement, the Economic Counsellor remembered, Mr. Wijnholds had observed that:

> "The staff supplies somewhat surprising data that show that no significantly larger incidence of crashes has occurred under pegged exchange rate regimes in comparison with flexible regimes, where a crash is defined as at least a 25 percent depreciation and a 10 percent increase in the rate of depreciation over the previous year. However, this comparison may lead us to the wrong conclusion regarding the choice of optimal exchange rate mechanism for developing countries and its consequences for Fund involvement as it overlooks one important factor: central bank intervention and reserve losses. Although not reported by the staff, it would be reasonable to assume that reserve loss in the case of a pegged exchange rate regime was much higher than in the case of more flexible regimes, including managed float, and such reserve loss induces a much larger scale involvement of the Fund, as evidenced by such cases as Mexico and Thailand. Thus a broader interpretation of the data reported by the staff may even highlight the advantages of more flexible regimes as they do not end up with higher incidence of crashes, while limiting the loss of reserves and subsequent assistance to the countries involved, and although such regimes result in higher day-to-day exchange rate volatility, this volatility can be hedged using market-traded instruments."

While that observation was clearly correct, it was important to note that virtually no developing countries had fully flexible exchange rate regimes, the Economic Counsellor commented. Almost all the developing countries actively managed their exchange rates, if not narrowly, than within fluctuation limits they considered to be tolerable.

Specifically with respect to the cases of Mexico and Thailand, it should be noted that in 1993/94, Mexico had had a floating exchange rate regime, the Economic Counsellor said. Not only did the peso have considerable flexibility de jure, it also had flexibility de facto. At that time, the peso had fluctuated within a crawling band of about 10 percent. Over the course of 1994, the peso depreciated from the maximum to the minimum levels within that band. However, Mexico's exchange rate regime had not been qualitatively different from, say, that of Chile, although it had been managed differently and in the context of different economic policies.

By contrast, Thailand had an absolute exchange rate peg, the Economic Counsellor continued. Nevertheless, both Mexico and Thailand had experienced significant exchange rate crises. Indeed, potentially any country that sent a clear signal to markets that there were limits beyond which it would not let its exchange rate go was potentially vulnerable to intense pressure on its exchange rate. However, for developing country governments, there was no viable alternative to making that type of commitment. In the absence of such an exchange rate commitment, developing countries' exchange rates would likely fluctuate even more violently than the exchange rates among the large industrial countries. Moreover, in the absence of such commitments, developing countries would find it very difficult to establish private markets of the depth and resiliency needed to stabilize their exchange rates.

As to the comparison between Chile and Mexico, there had been important differences not only in the way they had managed their exchange rates, but also in other policy areas, the Economic Counsellor noted. For example, the Chilean authorities had been committed to adjusting their policies in a way that would maintain the current account deficit at about 3 percent of GDP. While the current account position of Chile oscillated, the authorities had managed policies, including with respect to the exchange rate, in a way that would not allow the current account deficit to rise above the level of 3 percent of GDP. At the same time, the Mexican authorities had allowed their current account deficit to rise to almost 8 percent of GDP in 1993/94. At that stage, many analysts announced that the Mexican peso had become significantly overvalued and the markets had reacted accordingly. Similar conclusions had not been reached with respect to the Chilean peso.

Mr. Toribio considered that the main difference might not be between fixed exchange rate regimes or flexible exchange rate regimes, but between announced and unannounced exchange rate policies. Once a country announced its exchange rate policy—whether it was to maintain a purely fixed exchange rate, as in the case of Thailand, or a crawling peg within a band, like Mexico—it would become subject to market speculation. Countries that did not have announced exchange rate policies were less vulnerable, because speculation against their currencies was more difficult.

Mr. Eyzaguirre said that he differed from Mr. Toribio. The main lesson to be taken from the staff's analysis was the need to ensure consistency between the exchange rate regime and underlying domestic policies. Provided domestic policies were appropriate, a flexible exchange rate could be helpful to countries in dealing with large capital movements. In that respect, he could support the staff's conclusion that there was no optimal exchange rate regime; rather, the success of any exchange rate system was dependent on the pursuit of appropriate domestic economic policies that were consistent with that system.

Mr. Yao commented that he agreed with the staff's conclusion. He wondered how countries with sound macroeconomic policies could defend themselves against the contagion effects of market crises.

The Economic Counsellor noted that while defending an economy against spillover effects was not easy, it was possible to reduce a country's vulnerability to external shocks. For example, the contagion effects of the Thai crisis were likely to affect most severely the countries in the region with large current account deficits and banking sector problems. While other economies, such as Hong Kong and Singapore, were clearly not immune to the contagion effects, they were not likely to be hit as hard.

Mr. Toribio was correct to point out that a firm commitment to a hard peg could make it more difficult to adjust the exchange rate in response to a crisis—without suffering credibility losses—and it could make the currency more vulnerable to speculation, the Economic Counsellor considered. However, there was a need for caution in drawing too much from that conclusion, given the experience of countries with flexible exchange rate systems that had experienced exchange rate crises. In view of the large reserve losses associated with attempts to defend a fixed exchange rate, it would be important for countries with such exchange systems to respond to crises earlier rather than later. For example, Thailand would have been well advised to have acted earlier to adjust its policies, when the signals of trouble had first emerged. In the case of Thailand, only part of the loss in reserves was attributable to the efforts to defend the exchange rate from external speculation; part of it was attributable to Thai businesses that had borrowed in foreign-currency-denominated assets, and who had then sought forward cover either by buying reserves or forward contracts with the Bank of Thailand. Part of the reserves loss was also a reflection of the difficulties encountered in the financial and business sectors.

One of the main lessons to be drawn from the experience thus far was that developing countries, for good reason, actively managed their exchange rates, the Economic Counsellor stated. Therefore, it was important to ensure that policies were carefully coordinated to ensure that they were both realistic and consistent with the chosen exchange rate regime. In the event that circumstances called for an adjustment of the exchange rate and supporting policies, it would be crucial for countries to make such adjustments in a timely and credible manner in order to avoid volatile and even capricious market reactions.

The Chairman made the following summing up:

> Directors agreed that conditions were generally favorable for the continued expansion of world output this year and next. In the advanced economies as a group, solid growth with moderate inflation had been sustained, despite sluggishness in some countries. Robust growth had continued in much of the developing world. In Asia, although the impact of recent severe currency pressures in some countries was expected to result in a significant slowdown of output in the near term, the region's fundamentals remained strong and its longer-term outlook was not viewed as having deteriorated. The decline in output in the Russian Federation and in the transition countries as a group had apparently come to an end.
>
> Directors observed that there were many reasons to believe that the current world expansion could be sustained over the next several years: global inflation remained subdued and commitments to safeguard progress toward price stability were strong; medium-term plans to reduce fiscal imbalances were being implemented in many countries, which should help to contain real interest rates; and exchange rates among the major currencies appeared to be consistent with economic fundamentals, taking into account relative cyclical positions. Furthermore, among the advanced economies cyclical divergences remained sizable, suggesting that the projected strengthening of growth in Japan and continental Europe should support global demand as growth slowed to a more sustainable pace in those countries that had reached a mature stage in their expansions. Meanwhile, the projected strengthening of growth in the transition countries and continuing solid expansion in much of the developing world should stimulate and broaden the growth of world trade and output.
>
> A number of Directors cautioned, however, that there was no room for complacency about the risks and fragilities that confront individual countries and that could affect regional and world economic and financial conditions. Inflationary pressures could reemerge in countries that had reached high levels of resource use, while prospects for a sustained pickup in domestic demand in continental Europe and Japan remained uncertain. The process leading up to

European Economic and Monetary Union (EMU) could give rise to changes in investor sentiment in a context where potential EMU participants faced challenges related to budgetary strains and record levels of unemployment. And although capital flows to emerging countries had reached unprecedented levels, the continued availability of those flows was vulnerable to higher interest rates in world financial markets as well as to perceptions that such large flows might not be sustainable in all cases. The potential for significant corrections in some equity and bond markets was also noted.

Prospects and Policies in Advanced Economies

In their discussion of the advanced economies, Directors noted that, although growth in the first half of this year had far exceeded the U.S. economy's potential growth rate, growth was expected to be closer to potential in the remainder of 1997 and 1998. Noting the continued buoyancy in the stock market and the strength of consumer and business confidence, some Directors not only supported the moderate tightening in monetary policy earlier in the year, but also viewed as likely the need for further tightening later this year. Continued reduction in the fiscal deficit was expected in 1997; even though a balanced budget was projected for the year 2002, several Directors considered that a more front-loaded fiscal consolidation effort was warranted in such a favorable environment.

The performance of the Japanese economy had improved considerably since 1995, but uncertainties regarding the strength of the recovery had persisted. Directors commented that the lack of confidence partly reflected the severity of the recent downturn, continuing difficulties in the financial sector, and the need for substantial fiscal consolidation. The strengthening of activity since late 1995, coupled with supportive monetary policies, suggested that the recovery was sufficiently well established to withstand the fiscal consolidation planned for 1997 and 1998. Directors broadly agreed that, given the absence of inflationary pressures and some continued signs of weakness, initial steps to reverse the very easy stance of monetary policy should await evidence that domestic demand had regained momentum after the increase in the consumption tax last April. A number of Directors stressed that Japan's greatest challenge was in the area of structural reform. Despite progress in some areas, Directors encouraged the authorities to accelerate deregulation and structural reform, including in the financial sector, to enhance the prospects for robust growth over the longer term.

Directors observed that growth in Germany and France appeared to be picking up after a disappointing performance in 1995 and 1996. An easing of monetary conditions since early 1995, which stemmed from further reductions in interest rates and from the depreciation of the deutsche mark and the currencies closely linked to it, had contributed to recovery. Exports had accounted for much of the strength in economic activity. Consumer confidence remained low, linked to record levels of unemployment, the need for continued fiscal restraint, and job insecurity. Although cyclical unemployment was expected to decline, comprehensive labor and product market reforms were necessary to reduce joblessness to more tolerable levels. Most Directors believed that the current stance of monetary policy was appropriate, with favorable inflation prospects and fiscal retrenchment set to continue in both Germany and across the European Union (EU).

EMU and the World Economy

Directors considered that EMU, which was scheduled to begin on January 1, 1999, would constitute one of the most important developments in the international monetary system in the post–Bretton Woods period, and strongly welcomed the timely attention devoted to that issue in the World Economic Outlook. Directors noted the impressive degree of economic convergence achieved in Europe, including strengthened public finances, lower inflation and interest rates, and relatively stable exchange rates. Some Directors were of the view that the advances in economic convergence and the strong commitment to start EMU as envisaged had served to lessen considerably the risks and uncertainties in the run-up to EMU. A number of Directors stressed that the best way to minimize any remaining uncertainties about the start of EMU and to ensure that a sustainable and strong EMU began on time would be for countries to take fiscal actions in the remainder of 1997 and in 1998 that continued to demonstrate their commitment to the requirements of the Maastricht Treaty and of the Stability and Growth Pact, particularly through reforms that address the root causes of Europe's unemployment problem and excessive levels of public expenditure.

With regard to the fiscal criterion, several Directors noted that there was a risk that a number of candidates for membership, including France and Germany, might slightly exceed the deficit target. Several Directors, however, agreed with the staff that, particularly in view of the reductions achieved in cyclically adjusted deficits thus far, and the longer-term framework established with the Stability and Growth Pact on fiscal discipline, small excesses of actual deficits over the reference value should not be viewed as an impediment to EMU proceeding according to the agreed timetable. They were of the view that ad hoc fiscal measures aimed solely at meeting the Maastricht reference value in 1997 should be eschewed in favor of more resolute medium-term fiscal reforms, which were critical for the success of EMU. A few other Directors emphasized the virtues of strictly adhering to the Maastricht fiscal ceilings, taking into account possible negative effects of any divergence from the announced criteria.

Directors noted other challenges that still had to be faced during the transition to the single currency and for a successful monetary union to be sustained. They broadly agreed that, in addition to sound financial policies, improving Europe's labor market performance would be a critical factor for the success of EMU. Directors emphasized that comprehensive labor market reforms to reduce structural unemployment would not only help boost medium-term growth and improve fiscal performance, but also help Europe to adjust faster to adverse economic disturbances when the monetary union was in place and increase public support for the project. Directors also underscored that decisive labor market and product market reforms were essential for ensuring the medium-term growth and prosperity of Europe, irrespective of

EMU. Several Directors suggested that lessons could be drawn from the encouraging experiences of countries with more flexible labor markets, such as the United Kingdom and the United States and, in continental Europe, the Netherlands and Denmark.

Directors generally agreed that the independence of the European System of central banks, and its mandate and capacity to achieve price stability, should be well safeguarded by the provisions that had been put in place relating to its functioning. Directors generally felt that the exchange rate would not be a suitable nominal anchor for monetary policy in the euro area. They considered that the introduction of the euro would be accompanied by a significant restructuring of financial markets and instability in money demand relationships. Directors considered that the European central bank would likely use a wide range of indicators in the conduct of monetary policy, especially in the early stages of EMU. It was noted that transparency of monetary policy would be important in securing and maintaining the credibility of the European central bank.

A number of Directors observed that many EU members suffered from chronic fiscal problems, as indicated by rising government debt ratios, unprecedentedly large public sectors, and heavy and growing tax burdens. Most members also faced the prospect of worsening budgetary positions in the medium to long term as a result of demographic developments. Directors agreed that those problems would have to be addressed, irrespective of EMU. Persistent fiscal imbalances would not only adversely affect medium-term growth prospects in the EU, but could also produce pressures for undue relaxation of monetary policy.

Prospects and Policies in Developing Countries and Lessons from Recent Exchange Market Pressures in South East Asia

Directors welcomed the broadly improved performance and prospects in the developing countries, reflecting the fruits of stability-oriented macroeconomic policies and structural reform. Growth had become more widespread and was expected to remain strong, above the growth performance seen in the 1980s and early 1990s. They welcomed the low or declining rates of inflation and the generally prudent fiscal policies that had significantly reduced the threats to growth stemming from policy imbalances. Several Directors noted, however, that significant risks remained in a number of countries, owing to large external imbalances and fragile banking systems that had adversely affected investor confidence and the risks emanating from volatile capital movements. Those difficulties were not expected to significantly affect the generally positive long-term prospects of those countries, provided that disciplined macroeconomic policies and necessary structural reforms were implemented on a timely basis to ensure the elimination of unsustainable economic imbalances. Furthermore, Directors stressed that those policy efforts would have to be supported by a broader range of institutional reforms, the so-called second-generation reforms, aimed at increasing the efficiency of public administration, developing human capital, strengthening financial sector management, setting up transparent regulatory and legal systems, and improving governance. Such reforms would help establish and maintain private sector and investor confidence, and thereby lay the basis for sustained, high-quality growth.

Directors observed that the strengthening of growth in the developing countries of the Western Hemisphere was expected to continue in 1997 and 1998. While substantial progress had been made since the early 1990s in reforming government pension plans, in restructuring and privatizing state enterprises, and in reducing nontariff barriers and tariff rates, sustained long-term growth would require further efforts to address structural weaknesses, including, in particular, measures to improve the soundness of the financial sector. In the Middle East and Europe region, significant progress toward fiscal consolidation and the successful implementation of structural reforms had provided the underpinnings of the region's improved macroeconomic performance. To ensure improvements in growth rates in the medium term, Directors emphasized the need to continue structural reforms and to further lessen dependence on short-term capital inflows and volatile oil revenues. In Africa, including in many sub-Saharan countries, improved economic policies and structural reforms had contributed to higher growth and lower inflation, and growth prospects were favorable. Nevertheless, economic success had been unevenly distributed, and growth was projected to weaken somewhat in 1997, reflecting severe drought in much of North Africa, before recovering in 1998. In many countries, Directors emphasized the importance of deepening "first-generation" reforms aimed at attaining macroeconomic stability, improving resource allocation, and fostering savings and investment.

Directors remarked that Asia remained the fastest growing region in the developing world. Nevertheless, several Asian economies had recently experienced severe financial market pressures linked in part to concerns about large external deficits. The pressures had been the most acute in Thailand, where fragilities in the financial sector heightened concerns about the sustainability of the pegged exchange rate arrangement. Spillover effects from the crisis had been felt by other countries in the region, notably Indonesia, Malaysia, and the Philippines. In all of those cases, acute exchange market pressures eventually had led to the adoption of more flexible exchange rate arrangements. Several Directors stressed the importance of containing external deficits and reducing the reliance on foreign borrowing, especially foreign currency denominated short-term borrowing, so as to diminish the risk of disruptive changes in market sentiment. In that regard, Directors noted that the adoption of a strong adjustment program by the Thai authorities and the solid demonstration of regional and international cooperation would pave the way for a restoration of confidence and a gradual return to Thailand's characteristically strong economic performance. More generally, several Directors observed that to restore economic and financial market stability it would be crucial for all countries in the region to pursue sound macroeconomic and structural policies, strengthen financial supervision, and enhance transparency through the timely disclosure of economic and financial data.

Reflecting on the experience of developing countries generally, Directors noted that in an increasingly globalized world, where both the benefits of good economic management and the costs of inappropriate policies were amplified, "getting the exchange rate right" had become increasingly important for macroeconomic stability and for sustaining good economic performance. While the forces of globalization, especially the integration of financial markets, had opened new opportunities for many developing countries, they had also been accompanied by new challenges, including the necessity to adapt exchange rate arrangements to changing circumstances.

Directors observed that, reflecting the changes in the global environment since the early 1980s, a large number of countries had shifted toward more flexible exchange rate arrangements. A number of countries that had officially opted for a more flexible arrangement, however, continued to informally peg their exchange rates to one of the major currencies, particularly the U.S. dollar. Some Directors also remarked that the evolution of exchange rate arrangements in developing countries had been toward flexibly managed exchange rates rather than purely floating rates. As a practical matter, they noted, developing countries for the most part were not in a position to allow exchange rates to float freely as in the case of the major currencies. There remained a need for some active management and timely policy adjustments to help guide the exchange market and avoid excessive volatility and serious misalignments.

Directors concurred with the staff that while the choice of exchange rate arrangement had to be made on the basis of a complex set of country-specific factors, country experiences over the past two decades suggested that neither of the two main types of exchange regimes could be unambiguously ranked above the other in terms of macroeconomic performance. Several Directors remarked that, although exchange rate pegs had often been an essential element in disinflation strategies, once the domestic sources of inflation had been brought under control, increased flexibility in exchange rate management could be equally disciplining and in some cases more helpful in the face of external shocks that required domestic policy adjustments. Some Directors pointed out that, while there were many examples of pegged exchange rate regimes working satisfactorily for extended periods, there were also many examples of pegged exchange rates being adjusted too late in the face of capital flows that ultimately proved destabilizing. They further noted that increased exchange rate flexibility could have a strong disciplining effect on macroeconomic policies, might help to convey a more realistic perception of risk to both domestic and foreign investors and, in some cases, lead to more timely policy adjustments. Some Directors, citing the recent Asian experience, underscored the importance of moving to more flexible exchange rate systems in the face of sustained market pressures, and called for a further study of appropriate exit policies.

Directors agreed that regardless of the exchange rate arrangement, the maintenance of appropriate macroeconomic policies consistent with the exchange arrangement was crucial. They further observed that policymakers needed to have a flexible approach toward exchange rate arrangements as considerations affecting the choice of a regime might change over time. In that regard, Directors pointed out that, while good macroeconomic policies were definitely necessary, they may not be sufficient to prevent exchange rate volatility, especially in the face of short-run capital flows. A few Directors also emphasized that the orderly evolution of exchange markets in developing countries could be facilitated by greater policy coordination among the major industrial countries to avoid excessive volatility in the exchange rates of the main reserve currencies.

Prospects and Policy Challenges in Transition Countries

Turning to the transition economies, Directors welcomed the further progress in many of those countries, as evidenced by lower inflation and a widespread resumption of growth, but noted that many challenges remained to be addressed to safeguard and build upon the initial achievements. Among the countries more advanced in transition, most had continued to make good progress, but some countries had been adversely affected by exchange market pressures related to current account deficits. In that regard, recent events in central European exchange markets had demonstrated that, with the increasing integration of transition countries into the global financial system, the need to address external imbalances and structural weaknesses had become even more urgent. Among the countries less advanced in transition, much remained to be done, including introducing and strengthening the institutions of a market economy; improving financial systems, which were underdeveloped and plagued by nonperforming loans; further restructuring state-owned enterprises; strengthening property rights; and improving adherence to the rule of law.

Given the significant progress toward macroeconomic stabilization in most countries in transition following initial high inflation, Directors noted that the focus of monetary policy had shifted to the need to bring down inflation toward low single-digit rates. They emphasized that tight financial policies were a prerequisite for further reductions in inflation, but recognized that a number of obstacles were likely to prevent inflation from converging rapidly to the rates in advanced economies. Directors also stressed that monetary authorities in the countries in transition faced challenges not only in formulating monetary policy, but also in establishing the frameworks of instruments and institutions through which monetary policy can be effectively implemented in a market economy. Furthermore, they faced the challenge of fostering the establishment of efficient, market-based financial systems and dealing with banking sector problems. Directors also underscored the importance of further progress with industrial and financial sector reforms so as to reduce pressures for inflationary bailouts of ailing banks and enterprises.

Directors discussed the evolving role of exchange rate arrangements in countries in transition. They noted that fixed exchange rates had been beneficial in braking initial high inflation, but could be costly to sustain in the face of persistent moderate inflation, large-scale structural changes and capital inflows. Directors emphasized the need to adjust exchange rate regimes in a way that preserves hard-won credibility on inflation and does not fully give up the currency anchor used to bring inflation down. Directors particularly underscored the importance of appropriate macroeconomic policies to ensure economic stability, regardless of the type of exchange rate arrangement.

2. SUDAN—OVERDUE FINANCIAL OBLIGATIONS—FURTHER CONSIDERATION OF COMPLAINT WITH RESPECT TO COMPULSORY WITHDRAWAL; AND REVIEW OF STAFF-MONITORED PROGRAM FOR 1997

The Executive Directors considered a staff paper on further consideration of the complaint with respect to compulsory withdrawal of Sudan (EBS/97/149, 8/15/97). They also had before them a paper on the review of the staff-monitored program for 1997 (EBS/97/151, 8/15/97).

Mr. Sabir Mohamed Hassan, State Minister of Finance and National Economy for Sudan, made the following statement:

> I would like to register the appreciation of the Sudanese government for the understanding that the Executive Board has shown for Sudan's economic situation and its endeavor to facilitate Sudan's efforts toward normalizing relation with the Fund. We are also grateful to the management and staff for maintaining a constructive dialogue which has greatly assisted the government in implementing the policies that have been agreed in the context of the staff-monitored economic and financial program. As Directors are aware, the program has been monitored on a monthly basis, and the present staff report sums up the developments over the last six months. I am pleased to say that we are in full agreement with the staff's analysis and conclusions.
>
> Sudan has spared no effort to honor in a timely manner the schedule of payments as agreed with the Fund. The program is also on track, with fiscal consolidation being at the center of the adjustment strategy. These developments demonstrate a clear commitment of the Sudanese authorities to strengthen cooperation with the Fund.
>
> As noted in the staff report, several important steps have already been taken to strengthen public sector finances and improve the financial and exchange rate systems. On the revenue side, the official dealer exchange rate for customs valuation was adopted; tax exemptions have been curtailed; tax enforcement has been enhanced; and significant progress on technical preparation for the value-added tax (value-added tax) has been made. Regarding expenditures, petroleum subsidies have been eliminated, with domestic prices of petroleum products now being above international prices; an effective system of budget monitoring on a daily basis is now in place; and initial steps to introduce market-based instruments of government funding have been taken. In the financial sector, customer's financing share under Musharaka has been considerably increased and Murabaha rates have been adjusted upward. Also, reserve requirements on foreign currency have been imposed on commercial banks; interbank trade has been liberalized; and the operational framework of overdrafts facility has been improved. In the external sector, the new exchange rate mechanism is now in operation, and work is in progress for further improvement. In this regard, it should be noted that the spread between account-to-account rates and the joint committee rates has fallen below the targeted level. The surrender requirements of export proceeds have been drastically reduced.

The policies being implemented have led to significant improvements on several fronts. Real GDP is expected to grow by 5.5 percent in 1997 compared with a targeted growth of 4.9 percent. Inflation declined to 37 percent in July 1997 compared with 114 percent in December 1996, and the target of 70 percent by December 1997. Meanwhile, the overall external balance has improved, despite a worsening in the terms of trade.

The government of Sudan has presented its economic and financial program for the second half of 1997, having fully consulted with the staff and management. The program reflects a further tightening of fiscal policies and continued monetary restraint. Emphasis is also being placed on structural reform. The government is fully committed to implementing this program with determination in order to consolidate the gains achieved so far. In this connection, we hope that the Fund would use its good offices to give appropriate signals to the international community in order to help Sudan mobilize the requisite resources for its adjustment effort.

The government fully supports the observation of the staff that "by staying the course charted in the staff-monitored program, the government of Sudan is demonstrating its desire to enhance cooperation with the Fund." In this context, we welcome the staff's view that, subject to strong performance of Sudan during the remainder of the monitoring period in the fields of policy implementation and payments to the Fund, they envisage that a strategy for normalization of Sudan's relations with the Fund could be developed.

Finally, we are pleased to note that there are some positive political developments in the South of Sudan stemming from the regional efforts of the President of South Africa and the Intergovernmental Agency for Drought. This should create a better environment for economic growth and development.

Adding to his statement, Mr. Hassan stated that all benchmarks for mid-August had been met. Payments for August had also been met on time, even though it had been very difficult for the country to effect them, and hard choices had had to be made. Sudan had had to forgo some basic needs of the people to be able to pay the Fund. That demonstrated the priority that Sudan attached to its relations with the Fund. He hoped that making prompt payments would not be misunderstood as an indication that those payments were in any way easy.

The performance of the consumer price index for the month of August indicated a further deceleration in inflation, to less than 34 percent, Mr. Hassan continued. Also, the spread between the bank rate and the account-to-account rate had narrowed further, to well below 9 percent. That compared to a September benchmark of 11 percent. Government borrowing from the banking system in August had remained below the program ceiling.

On the political front, in the preceding two weeks a start had been made on the implementation of the Khartoum Peace Accord, which had been signed by the government and a number of the rebel factions, Mr. Hassan went on. The Accord had been ratified by the National Assembly. The Chairman of the Coordinating Council had been named, and the process of choosing the members of the Council was under way. There was wide regional support for the Peace Accord. In the following week, a meeting was expected to take place under the chairmanship of President Mandela, which would be attended by members of the various factions, the Chairman of the Organization of African Unity, and a number of other important African leaders. Sudan was optimistic that those efforts would give the peace process new momentum.

Sudan's efforts to improve and normalize its relations with bilateral donors and regional and international institutions were being reinforced, and Sudan believed that the Fund could be of assistance in that regard in many ways, Mr. Hassan concluded. Support by the Fund and the international community was necessary for Sudan to build on the progress made, and to continue with its efforts. He hoped that such support would be forthcoming.

Mrs. Guti made the following statement:

> The decision taken by the Board in March 1997 that Sudan's economic program was of a quality that warranted monitoring by the staff marked a turning point in relations between the Fund and Sudan. The staff report on the review of the program shows quite unequivocally that this turning point has been for the better—a vindication of the wisdom and patience exhibited by both the Fund and the Sudanese authorities in trying to find a window of opportunity even when it seemed that a nadir had been reached. Indeed, the staff appraisal offers a breath of fresh air in commending the authorities for the scope and achievement of the program and for their intention to continue to consolidate the gains made so far. Undoubtedly, there is a long and difficult road still ahead. But there is a saying that the longest journey begins with the first step. The Sudanese authorities have indicated that they intend to stay the course, the goal being to restore normal relations with the Fund and to put their economy on the path of sustainable growth and development.
>
> It is reasonable to say that the program meets the generally acceptable standards of what constitutes "strong, comprehensive adjustment." That it is characterized as a staff-monitored program should not detract from this fact. There are, at least, four key elements that lend credibility to this program—elements that tend to define the basic thrust of Fund-supported programs: (1) it is distinctly focused on reducing inflation; (2) it furthers the process of economic liberalization, including the exchange rate regime; (3) it relies on prudent fiscal and monetary policies as the bedrock for establishing a more stable macroeconomic framework; and (4) it incorporates structural and institutional reforms geared toward enhancing the role of the private sector as the basis for sustainable growth.
>
> Considerable efforts have been expended to implement this program. It has not been easy, against the background of a significant deterioration in Sudan's terms of trade and the quite small amount of external assistance. That the authorities have persevered to this point is testimony to the self-realization that the program is good for the long-term interest of the Sudanese economy. Meanwhile, they have adhered scrupulously to the payments schedule that was agreed to early this year, and this is clear testimony to Sudan's recognition of the preferred creditor status of the Fund.

The recent payments performance and the satisfactory implementation of the program provide an environment that is consistent with the test of cooperation as defined under the enhanced strategy on overdue obligations. This should be acknowledged by the Fund, not only because it would be fair to Sudan or would help the authorities sustain the political consensus for continuing down the difficult road of reform, but also because it brings credit to the Fund as a cooperative institution that is firm and serious about its rules without loosing the capability of finding practical solutions to difficult problems.

The authorities are committed to working in good faith with the Fund. Evidence of this is the indication they have given of their willingness to do more to improve their payments performance as conditions permit. In the meantime, they are deepening the process of economic reform with a view to moving as quickly as possible toward full normalization of relations with the Fund.

There is reason for optimism. The picture that emerges from the staff report is one of a government committed to keeping the program on track. Contingency revenue measures are being introduced to ensure that the budget deficit remains within the program limit. The revenue situation is also being helped by improvements in tax and customs administration. Meanwhile, the introduction of a value-added tax beginning in 1998 is under advisement. The Fund has provided invaluable technical assistance in this area. The tightening of credit policies is expected to reduce inflation to below the original target. Exchange rate policy will continue to have an important role. The intention is to move toward a market-based exchange system that is sustainable. The authorities are using the lessons from previous failed attempts to unify the exchange rate to devise a phased approach that will allow the proper sequencing of measures.

Action is also being taken to improve the supply response of the economy. In this connection, it is to be noted that the second phase of the privatization program is under way. Labor laws are under review, as well as laws on investments. Consideration is also being given to antimonopoly legislation. All of these are intended to create a more enabling environment for the development of the private sector. The authorities are also emphasizing improved health care and education as a means of increasing productivity.

All in all, the Sudanese authorities have presented a good program. They also are demonstrating commitment to seeing it successfully implemented. Restoring relations with the Fund is for them a matter of priority. The authorities need the support of the international community to see them through this difficult period of adjustment and reform.

Extending her remarks, Mrs. Guti said that she wished to emphasize that significant progress had been made since the previous Board meeting on Sudan. She hoped that the discussions that afternoon would be in keeping with that progress. She hoped that the text of the decision that the Board would take at the end of the meeting would also be in keeping with the progress made, and that it would reflect the continued efforts of the country.

Minister Hassan then left the meeting.

A Deputy Director of the Middle Eastern Department stated that, based on the preliminary data that the staff had received for July and August and discussions the staff had had with the authorities on the preceding day and before the current meeting, the staff could confirm that inflation on a year-to-year basis had declined in August to 32 percent, compared with 37 percent in July, and the program target of 65 percent. The exchange rate in the free market had remained stable for several months, and the spread between the official exchange rate and the account-to-account rate was now 8.6 percent, close to the program target of 8 percent for the end of the year.

The fiscal developments had been broadly on target as well, the Deputy Director continued. The central bank credit to the government had been below the program ceiling, about $2 billion. Preliminary monetary data in July showed a large decline of government deposits with the Bank of Sudan to finance imports of petroleum and sugar. The authorities had noted that that decline would soon be reversed when the import proceeds were sold, and in fact, data for the first two weeks of August indicated that that was happening. In any case, the staff had initiated with the authorities a discussion on the implications of such a decline in government deposits for the observance of quantitative benchmarks for net domestic credit.

The authorities had complied with the three actions set as structural benchmarks for August, the Deputy Director confirmed. One had been to submit to the staff a proposal on further liberalization of gasoline imports, which encompassed the promotion of private sector involvement in the importation and marketing of diesel and crude oil. That was in line with giving a bigger role in that area to the private sector, and reducing the role of the public sector. In parallel, the authorities were also supposed to further reduce the export surrender requirements and raise export retention requirements. The authorities had submitted a proposal on those reforms to the staff for comments.

Another structural benchmark had been to reduce the surrender requirements and increase the retention ratios by 5 percentage points on 13 commodities, as part of the ongoing efforts to promote exports, and that had been achieved, the Deputy Director related. The authorities had also submitted to the staff draft prudential regulations on foreign exchange exposures and other structural benchmarks. The staff was discussing with the authorities all of those proposals, which were to be implemented in September and beyond.

As regards payments to the Fund, the payment for August had been received on August 12, the Deputy Director concluded. That brought the total payments thus far in the current year to $41.1 million, compared with the programmed amount of $58.3 million for the full year.

Mr. Shaalan made the following statement:

> In contrast to the past, the Sudanese authorities are to be commended for the implementation of the economic program agreed on with the staff last March despite a continued difficult political situation. It is clear from the report that Sudan has strengthened its cooperation with the Fund both in terms of payments and policy implementation. Sudan's arrears to the Fund are now well below their peak level of February 1995. This is a significant improvement particularly against the backdrop of virtual absence of foreign assistance.

On the policy side, the much improved fiscal policy backed by continued tight monetary management made it possible for Sudan to reduce the 12-month inflation rate to 37 percent in July 1997 from well over 100 percent in December 1996, cut the budget deficit on a cash basis to less then 1 percent of GDP, the lowest level in years, and steadily narrow the spread between the free account-to-account and the official dealer exchange rates to below the program ceilings. Steps are also being taken to implement a number of key structural reforms in the fiscal, monetary, and external areas. In contrast to the past, the turn around in economic performance in Sudan during the first half of 1997 has been noteworthy and we urge the authorities to continue firmly on this path. We commend the staff on the well-written and focused paper and for their continued hard work on the demanding case of the Sudan.

From reading the report, there is no disagreement between the authorities and the staff on the thrust of the policy requirements for the second half of 1997 and over the medium term. In fact there is general agreement on the need for further consolidation and broadening the reform effort to achieve durable gains in disinflation and create an environment conducive to higher levels of growth to alleviate poverty level which is high in Sudan. To ensure attaining the fiscal targets of the program, we are encouraged that the authorities introduced temporary contingency revenue measures in anticipation of the additional expenditures during the second half of 1997. Over the medium term, the authorities must vigorously pursue tax administration reforms in parallel with broadening the tax base. In this regard, the preparations for the introduction of the value-added tax in the context of 1998 budget is most welcome. On the expenditure side, further reforms of the expenditure control, monitoring system and ensuring that extra budgetary expenditures do not emerge again, are needed to avoid slippages during the remainder of the program period.

The steps taken in the financial sector are also welcome. In particular, we are encouraged that the adjustments in the cost of borrowing resulted in positive levels in real terms. Further structural measures are planned as outlined in Box 6, to strengthen bank soundness, monetary and public debt management.

Finally, we share the staff's view that, by deepening the current reform efforts and normalizing financial relations with external creditors, Sudan could move to a rights accumulation program. In this connection I would like to propose a change in the decision No. 3 p. 8 of EBS/97/149 third line would read "could provide the basis of a Rights Accumulation Program." With these remarks we support the proposed decision and wish the authorities every success in continuing their reform agenda.

Mr. Shields commented that he had seen no statistics that would lead him to the conclusion that the level of Sudan's arrears to the Fund was well below the peak. He wondered what Mr. Shaalan had had in mind when he had spoken about a substantial reduction in Sudan's arrears to the Fund.

Mr. Shaalan said that the arrears were well below what had been the past record—about $20 million below the peak of February 1995.

Mr. Shields said that that was against a background of total outstanding arrears of nearly $1.2 billion.

Mr. Newman made the following statement:

> Sudan's recent performance on policies and payments to the Fund under the staff-monitored program clearly represents an improvement in cooperation with the Fund. However, it is important to place this effort in its proper perspective. The program which Sudan has been following in the last few months was widely criticized in February as a weak effort in view of the pressing needs of the economy. Mrs. Guti's characterization of the program as "strong comprehensive adjustment," therefore, strikes us as somewhat of an exaggeration, even by Sudan's standards.
>
> The payments to the Fund were also modest, given the size and longstanding nature of Sudan's arrears and the continuing financial cost to the institution and to its members. I would agree with Mr. Shields that Mr. Shaalan's characterization of the payment as a significant reduction in the arrears to the Fund as a mischaracterization. I would also note that arrears to other creditors continue to rise.
>
> We also find the staff appraisal misleading, although we understand their desire to put Sudan's performance in the best possible light in view of the intensive staff effort over the past year, and we congratulate them on their effort for getting as far as they have.
>
> Improvements in both growth and inflation owe much to favorable weather conditions and oil windfalls, which substantially eased the policy constraints imposed by the program. The staff appeared to acknowledge the key role of temporary factors in the background section, but not, however, in the appraisal.
>
> I would also note that we welcome the Minister's indication that the inflation rate continues to decline, and in those circumstances, I was somewhat surprised by the reluctance of the authorities to reduce the target from the 65 percent level, which raises some questions about whether or not they will continue to follow policies that will bring the inflation rate down much further.
>
> The decline in the fiscal deficit was also due primarily to increased revenue, especially from petroleum-related activities, but still remains above 10 percent of GDP with tax revenues a minuscule 2.2 percent of GDP.
>
> The so-called reforms in the trade regime have left maximum tariffs at 100 percent and average tariffs at over 20 percent, and additional trade taxes are being introduced to bolster revenues. We would agree with Mr. Shaalan that it is essential that the proposed value-added tax be introduced at an early

date to improve revenue performance and to reduce reliance on distortionary trade taxes.

The reduction of the spread between the official and the market exchange rate is also welcome, although as we said in February, a faster realignment was warranted to curb a current account deficit that remains in excess of 20 percent of GDP and to reduce the budgetary impact of petroleum-related activities.

We would agree with Mrs. Guti that even the longest journey begins with the first step. In Sudan's case, however, the journey is indeed a long one, given the mismanagement of the past. Unfortunately, the initial step has been modest and certainly not commensurate with the task ahead. We would certainly hope that Mr. Shaalan is correct that the authorities will move forward from the current situation to introduce an even more fundamental reform of the economic system in the period ahead.

In these circumstances, however, we consider the proposed decision somewhat rose colored and inconsistent with the current situation, let alone future needs. We would like to suggest some modifications to provide greater balance and to more fully reflect the compromise decision agreed in February, but we will wait to do so until the Board has an opportunity to present its views and we come to the specific text of the decision later on.

Mr. Mirakhor made the following statement:

Let me first thank the staff for its untiring efforts in monitoring the program with Sudan. I know with the limited resources available to the Middle Eastern Department, this was a major task, and it is therefore all the more appreciated.

I wish also to commend the Sudanese authorities for their significant progress in policy implementation and their close cooperation with the Fund under very difficult circumstances. I fully support and associate myself with Mr. Shaalan's statement, including his proposed amendment.

I am pleased to learn from His Excellency Mr. Hassan's and Mrs. Guti's helpful statements that there is full agreement between the authorities and the staff on the latter's analysis and conclusions. I am particularly pleased to note from the staff's assessments that the government of Sudan has complied with the schedule of payments to the Fund, committed at the Executive Board meeting of January 31, 1997. By staying the course charted in the staff-monitored program, the government is demonstrating its desire to enhance cooperation with the Fund, and in light of this statement, I believe that this assessment makes Mr. Shaalan's proposed amendment highly pertinent.

By March 1998, Sudan would have completed one year of full-track record, and Mr. Shaalan's proposed amendment is an appropriate way for the Board to acknowledge the commitment of the authorities for the implementation of a strong staff-supported economic program, while it has fully honored the mutually agreed schedule of payments to the Fund, which, together, demonstrate full cooperation of Sudan with this institution.

With these remarks, I wish the Sudanese authorities all the best in managing their economy, and also for a quick resumption of peace in Sudan.

Mr. Al-Tuwaijri made the following statement:

The Sudanese authorities' adherence to the economic program and their increased cooperation with the Fund are welcome. These efforts are already paying dividends. As noted in the staff paper, significant improvements have been made on several fronts over the past few months. I also welcome the authorities adherence to the payment schedule to the Fund.

The challenge now is to intensify the adjustment and reform efforts in order to consolidate the progress made so far and move the economy further toward a sustainable growth path. In this connection, the program for the second half of 1997 is encouraging. It is essential that the program be strictly implemented and that Sudan continues to cooperate closely with the Fund both on policies and on payments to the institution.

Finally, I would like to thank the staff for its efforts and diligence in dealing with Sudan.

With these remarks, I support the proposed decision and wish the authorities further success in addressing the economic challenges facing them.

Mr. Rodríguez made the following statement:

We commend the Sudanese authorities for their efforts in accomplishing the economic goals set out under the staff-monitored program, during the first half of 1997. We must acknowledge that macroeconomic performance was on track and quantitative and structural benchmarks were met. Moreover, payments to the Fund have been made as committed.

The authorities have maintained a tight fiscal policy, prudent monetary and credit policies, and have made progress toward unification of the exchange rate system. It is impressive that, despite a worsening terms of trade, the overall external balance improved. Inflation has declined and real GDP is estimated to grow in 1997 by 5.5 percent compared with the initial program projection of 4.9 percent.

This very impressive performance must be deepened with the implementation of structural benchmarks that would allow the sustainability of the reform effort in the medium term. Several tasks are ahead: in the fiscal policy, the contingency revenue measures agreed under the program must be replaced by permanent programs, such as the value-added tax and tariff reforms. In the monetary sector, we support the staff's recommendations. We commend the authorities commitment to accelerate payments beyond the schedule, as balance of payments developments permit, and to move toward normalizing financial relations with creditors.

We should be confident of the authorities' commitment to achieve these reforms, particularly after their recent remarkable performance; however, the authorities will require a stronger commitment so as to succeed in the ambitious goals ahead.

With these remarks, this Chair supports the Proposed Decision and wishes the Sudanese authorities every success in their future challenges.

Mr. Disanayaka made the following statement:

Since our last Board meeting on February 12, 1997, regarding Sudan's cooperation with the Fund, we decided to call for monthly reviews on Sudan's adherence to the staff-monitored program. It is encouraging to note that Sudan has been making steady progress in all directions. We congratulate the authorities for this.

The accompanying report provides a complete survey of the progress the country has so far achieved. In implementing the staff-monitored program, it also gives a picture of the work remaining for the rest of the year. We are reassured of the authorities' commitment, as contained in the memorandum of understanding, which discusses the measures taken by them so far in the program and indicates a policy agenda for the second half of the year. We also welcome the Minister's statement, and are reassured by his commitments.

On the fiscal front, we welcome the measures taken toward strengthening tax collection, restraining expenditure, and moving to a unified exchange rate by the beginning of 1998. The authorities' firm commitment to attain the program's fiscal targets is further evidenced by the introduction of an intermediate supplementary budget containing additional revenue measures totaling about .4 percent of GDP, to offset additional expenditures expected in the second half of 1997.

On the monetary front, a tight credit policy has been continued which, coupled with the buildup of the petroleum stabilization fund, has contained credit growth and curbed inflationary pressures. This is joined by the rapid decline in inflation. The authorities have taken several important steps toward strengthening the prudential regulation of the banks, introducing new market-related business practices, and improving monetary management in line with Islamic banking.

On the external front, we commend the steady progress that the authorities are making toward evolving a unified market-based exchange rate system. This would certainly clear up many of the distortions in the existing operation of the exchange rate regime, and would contribute to greater efficiency of foreign exchange markets. We would, however, like to urge the authorities to establish a viable regulatory and operational framework for effective support of the financial markets, as a unified exchange regime could be sustained only in an environment of efficient and well regulated foreign exchange and financial markets. Past experience shows that slipshod efforts would not do; effective regulatory machinery will be the key to success here.

With a view to revitalizing the external sector, the authorities are planning comprehensive trade and tariff reforms. Certification requirements are to be gradually relaxed, and the importation of coal, oil, and diesel is to be thrown open to the private sector. The authorities are also planning to launch a second wave of privatization covering about 37 public enterprises, including some of the largest in Sudan, such as Sudan Airways and the Sudan railways. These are already significant steps.

We are pleased with the arrangements the Sudanese authorities are making to normalize relations with their multilateral and bilateral creditors. In this respect, we appreciate their continued recognition of the Fund as a preferred creditor and the fact that they are giving the highest priority to their arrears to the Fund. We are also very pleased with the reaffirmation of the authorities' commitment to continue their repayments to the Fund without any interruption. Indeed, the authorities have expressed their eagerness to enhance their payments with the expected windfall profits occurring from the newly discovered oil fields toward the end of 1998.

The macroeconomic stabilization and structural measures taken so far by the Sudanese authorities have served them well. Inflation has declined rapidly, GDP growth is estimated to climb a little higher than was projected in the program, and the external sector would be sustained despite an adverse terms of trade position. In the memorandum of understanding, there is a clear indicator of the authorities' determination to put through the reform program in the period ahead, building upon the gains already made. The structural benchmarks for the program during the second half of the year have been set in line with this strategy. The authorities deserve all encouragement and assistance to proceed along this path, as well as to fulfil their desire to normalize at an early date their relations with creditors, including the Fund.

If the authorities continue to keep up their commendable track record—in the reform agenda as in the repayment schedule—the Fund could continue to extend its technical assistance, particularly in areas such as the unification of the exchange rate, where it would appear that the authorities need help urgently. Perhaps it would also not appear too early to consider assisting the country to work out an appropriate medium-term program to succeed the present staff-monitored program, which would lapse at the end of the year. Such a program, as the staff has pointed out, would help deepen the reform program in the medium term, as well as assist the country to normalize its relations with external creditors. It would also help the country to move to a rights accumulation program if such a program were to remain available. Against this background, we have no hesitation in supporting the draft decision proposed by the staff, subject to the amendment proposed by Mr. Shaalan.

Mr. Kafka made the following statement:

We would like to acknowledge the change in the political and economic policy stance in Sudan and congratulate the staff on the success of its work. The Sudanese authorities have demonstrated their willingness to collaborate with the Fund, both through their action to correct imbalances and advance in the stabilization process, and through their strict adherence to the payments schedule. We believe that the Fund should continue to support Sudan in their challenges ahead, and therefore we endorse the proposed decision.

Policy efforts are already starting to bear some fruit despite the deterioration of Sudan's terms of trade. With inflation declining and output expanding, the authorities should be encouraged to maintain a tight fiscal and monetary stance, and continue to reduce—progressively—the spread between the two existing exchange rates. The introduction of temporary contingency revenue measures is welcome.

Having said this, we would add that the structural reforms being considered by the authorities are of upmost importance, in particular, the plans to introduce a value-added tax, the decision to proceed with the second phase of privatization, and the measures to strengthen public debt management and bank soundness. We would also encourage the authorities to go ahead with the idea of using part of the windfall in the oil sector to accelerate repayments to the Fund.

Like Mrs. Guti we believe that "there is a long and difficult road still ahead," but we look forward to continue to observe improvement in the Sudanese macroeconomic performance in the forthcoming monthly reviews. We wish the authorities the best.

Mr. Ismael made the following statement:

We are very much encouraged by Sudan's payments and policy performance thus far in 1997. Qualitative and structural benchmarks have been met and the authorities have fully complied with the payments schedule to the Fund. Moreover, macroeconomic performance is showing solid signs of improvement, and the authorities have given strong indications that they intend to stay the course and to continue their efforts to restore normal relations with the Fund. Overall, we are in broad agreement with the staff's analysis and policy recommendations, and we can associate ourselves with the views expressed by Mr. Shaalan and Mr. Mirakhor.

The progress made up to now needs to be sustained and even strengthened. In this context, we welcome the emphasis being placed in the program for the rest of the year on fiscal restraint, tightening of credit policy, with further efforts toward exchange rates convergence, and accelerating structural reforms.

Fiscal consolidation should remain a major objective of the authorities. In this regard, we would encourage them to continue their efforts aimed at further strengthening tax and customs administration. The phased introduction of the value-added tax in 1998 should help to broaden the tax base. We also find appropriate the staff recommendation to accelerate the process for tariff reform and to rationalize the tax system. Strengthening of the expenditure control and monitoring system should also be pursued.

In the monetary sector, the present stance has been appropriate and should be maintained so as to make further progress toward lowering inflation, while the reform of the financial sector could be accelerated with the aim of enhancing its role in the economy

On exchange rate policies, we note that the authorities are making good progress toward a unified market-based exchange rate arrangement. The gradual approach taken by the authorities has been appropriate as it has given them the time to undertake the necessary structural reforms and to phase in the operational and institutional framework for tight financial policies. However, efforts to liberalize the external sector should be accelerated, and the regulatory framework should be simplified.

We also commend the authorities for the wide range of structural measures taken. From the staff paper, we note that they intend to take additional actions in most areas of the economy, and also to implement a comprehensive program of public enterprise reform, including the privatization of some major companies. These actions will contribute to improving the supply response of the economy and make it more competitive.

All in all, we commend the Sudanese authorities for having strengthened significantly their adjustment efforts and for the strong commitment shown to the adjustment process. As Mrs. Guti notes in her statement " the recent performance provides an environment that is consistent with the test of cooperation as defined under the enhanced strategy on overdue obligations." In the circumstances, we can support the proposed decision with the amendment proposed by Mr. Shaalan, and we are also of the view that continued satisfactory performance in 1997 should set the ground for starting discussions toward a medium-term arrangement with the Fund.

Mr. Esdar made the following statement:

Like other speakers, I welcome the fact that, since our last meeting on the subject, the Sudanese authorities have complied with the agreed economic program and have observed the payment schedule. This is certainly an important first step to improve cooperation with the Fund. Therefore, I can go along with the suggestion not to proceed with the recommendation to the Board of Governors regarding Sudan's compulsory withdrawal at this time. However, this is only the first step in the long process of normalizing Sudan's relations with the Fund and the donor community, and indeed, like Mr. Newman has said, we have to put the achievements into proper perspective against the background of where we started.

The program agreed last February was seen by many Directors as a kind of minimum requirement. Many Directors expressed concern at that time that progress under the program—in the area of exchange rate unification, for example—was not sufficient, and also that the monetary and fiscal objectives of the program were on the weak side, and the bare minimum. Therefore, we strongly encourage the Sudanese authorities to use the momentum of reform and to engage in an ambitious medium-term stabilization and reform program that could be monitored further by the staff.

It is also crucial that Sudan demonstrate the spirit of cooperation by increasing its payments to the Fund in order to reduce the stock of arrears, which is still at an unbelievably high level of about $1.2 billion. The improved balance of payments situation should provide some flexibility in this regard. We also expect that the commitment to use future oil proceeds for increased repayments should be reconfirmed, and the necessary institutional steps to establish the announced escrow accounts should be taken in a timely manner.

We also urge the Sudanese authorities to make every effort to improve and normalize their relations with the other multilateral and bilateral creditors. Without the support of those donors, Sudan has little realistic chance to overcome its external imbalances. In this regard, I was very disappointed to note that arrears vis-à-vis bilateral donors have continued to increase.

Despite this progress, the situation of Sudan is still very serious. I am not sure whether the proposed decision reflects this seriousness adequately. I would like to ask the staff why paragraph 2 of our previous decision on Sudan was not included in the proposed decision and, again, would like to have more comments about the legal consequences of a change in the decision in this regard. I will propose some modifications to the decision later in the meeting. I cannot support Mr. Shaalan's suggestion.

Mr. Zamani made the following statement:

The staff report provided a clear picture of the efforts and commitment on the part of the authorities in Sudan in persevering to carry out the economic program that had been developed with them, as well as their determination to fulfill their financial obligations. This was carried out under extremely difficult conditions. In contrast with the economic scenario during the last review, this review leads us to commend the Sudanese authorities for the positive outcome and for their ability to meet the main targets as set out under the Fund-monitored program. A great potential has been opened up and, based on current policies and commitments, more economic achievements could be expected to be accomplished in the months to come.

It is still too early to tell the medium-term outcome of this episode, as much more difficult hurdles have to be faced in the future. On reflection, however, we might have taken, earlier this year, a different route in tackling this problem. The route we have finally chosen may prove to be one of those numerous instances where the Fund has made the right decision. Now that we have been party to the recent positive changes and developments in Sudan, we have now to assist and encourage the authorities to follow through and intensify their efforts.

It is encouraging to note the commitment of the authorities to improve its relations with all the creditors, donors and the Fund. I, therefore, agree with the draft resolution on Sudan. This approval comes with a wish that, in the not too distant future, the reference to the Managing Director's complaint and all its implications will be dropped from any report and discussion on the Fund's relations with Sudan.

Lastly, I wish to thank the staff for the excellent report and the continued efforts in working with the authorities in the formulation of prudent policies and the implementation of needed reforms.

On this note, I wish the authorities success in their endeavors.

Ms. Srejber made the following statement:

I note with satisfaction that the conditions contained in the Executive Board Decision on Sudan, adopted February 12 of this year, have been broadly met. I would like to make a couple of comments.

It is a welcome sign that after 12 years of not fulfilling their obligations to the Fund, the Sudanese authorities have showed clearer intentions in the last few months to meet their commitments of repayment of arrears and implementation of sound economic and structural policies. That gives some, although still very distant, prospects of a reestablishment of a normal relationship between the Fund and Sudan in the future. However, taking into account that the oil prices and the weather have contributed to the recent more favorable developments, the fragile situation and the very short track record of acceptable policies and payments to the Fund, I believe it is premature at this stage to make a full-scale assessment of the situation. The commitments being undertaken so far by the Sudanese authorities are the minimum required to regain the trust of the international community and build up sound economic fundamentals. The Sudanese authorities need to steadfastly press ahead with broader and deeper economic reforms, and strictly adhere to, and preferably increase, the agreed payments to the Fund.

I thus associate myself with the views expressed around the table that tighter economic, financial and structural policies are required in Sudan, and that there is absolutely no room for complacency. In particular, with regard to the monetary developments in Sudan, in a follow-up of the positive, although slow, convergence of the official and the parallel market-based exchange rates, I would have preferred to see at least some kind of commitment on this front for the upcoming period. However, neither the letter of intent, nor the staff papers seem to contain any such information. This Board stressed during the last Article IV consultation in February the importance of moving rapidly to a transparent and unified market-based exchange rate arrangement. The staff's comments would be appreciated.

Having said that, I acknowledge that the Sudanese authorities should not be discouraged, but encouraged to increase their efforts. We should communicate very explicitly to the authorities that many challenges still remain and much more effort is needed on the reform path and on regularizing the arrears. I will come back later to my views on the proposed decision after I have heard all proposed changes, including those Mr. Newman indicated he would propose later.

Mr. Bernes made the following statement:

Let me first say that I am pleasantly surprised with Sudan's performance over the past few months both in terms of the implementation of the staff-monitored program and Sudan's adherence to the agreed-to stream of repayments to the Fund.

What the staff report shows is the first evidence of real effort on the part of Sudan to enhance its cooperation with the Fund and begin to establish a pattern of reform necessary for growth.

The agreement we reached last March was that if Sudan adhered to its commitments, we would not recommend its compulsory withdrawal to Governors prior to the 1997 Annual Meetings—although there was clearly a basis for such action at the time. I am pleased to acknowledge that the conditions are now such that I can stay my earlier support of a recommendation for compulsory withdrawal—assuming, of course, continued implementation of the program, timely payments, as agreed, for the remainder of 1997, and an acceptable plan of action for 1998 is adopted.

I am a bit concerned, however, with the characterization of the staff-monitored program in Mrs. Guti's statement as "strong and comprehensive adjustment." Indeed, I recall that, at our March discussion, Directors made it clear that the staff-monitored program should not be considered of a quality required for a regular Fund program and that this should be made clear in any Fund communication at the time. I believe this message needs to be reiterated to ensure that the extent of the Sudanese effort to date is realistically assessed.

I am also reminded that a significant number of Directors at our March meeting made it clear that adherence to the agreed commitments would not necessarily lead to Sudan's eligibility for a RAP or a more formal Fund arrangement and if I recall correctly, it was Mr. Shields who urged management to make sure this was clearly communicated to the authorities.

Therefore I want to make it clear that I do not believe that there is yet a justification or basis to undertake any thing other than a staff-monitored program for 1998. As such, I believe we should consider amending Section 3 of the proposed decision to make clear that what is envisaged is a continuation of the current approach. This in no way reflects disapproval with the efforts of the Sudanese authorities since March, but it must be remembered that they are not simply emerging from a program that went off track or a simple failure to complete a midterm review. The track record against which we must weigh the emerging commitment of the authorities has at its core a decade of noncompliance and massive arrears accumulation. A mere six months of satisfactory performance is not enough to completely reverse this, although, as Mrs. Guti has suggested, the "long and difficult road..begins with the first step."

That the authorities have expressed a credible desire to enhance their cooperation with the Fund is a welcome sign and clearly justifies the continued provision of technical assistance to the Sudanese authorities and frequent monitoring of progress in reform. But I believe our next step in the full regularization of relations between Sudan and the Fund must be discussion on strengthening both repayments and policies in 1998. What we achieved in 1997 was a stabilization of arrears, we must now turn to reaching agreement on a stream of payments that, in a sustained fashion, begins to bring those arrears down. Only then can we seriously contemplate an intensification of our engagement and without an evolution to such action, future consideration of compulsory withdrawal cannot be ruled out.

Mr. Han made the following statement:

The Sudanese authorities should be commended for their good performance, in terms of the repayment of arrears to the Fund and the implementation of the staff-monitored program. I also would like to thank the staff for the formulation of a feasible repayment schedule and well-tailored program, and also for a good job done by the staff in monitoring the implementation of this program. I agree broadly with the staff's appraisal and would like to limit my remarks on a few points for emphasis.

First, this chair has been of the view that on the one hand, the Sudanese authorities should pay highest attention to the issue of its arrears to external creditors. Any further deferment of the settlement of the arrears will ultimately hurt the Sudanese people and the authorities themselves. The authorities are requested to speed up the process of normalizing financial relations with external creditors (the Fund in particular, who is Sudan's major creditor) in a serious and prompt manner; on this point, it's pleased to see, the Sudanese authorities have kept their commitment on the repayment of their arrears to the Fund on schedule. On the other hand, the Fund should also exercise more patience over Sudan, one of the poorest countries in the world. The extreme measure, namely the compulsory withdrawal of Sudan's membership in the Board of Governors of the Fund, could not solve the arrears problem but could incur more losses to the Fund, and is against the objective and responsibility of the Fund in the international financial system.

The sustainability of Sudan's repayment of arrears to external creditors, depends fundamentally on the further improvements in the balance of payments situation. Thus the improvement of terms of trade, and the strengthening of the external sector are crucial. The disinflation trend of the Sudanese economy which is due to the tight fiscal and monetary policies and the measures adopted by the authorities to enhance exports rather than imports is most welcome. But the road ahead is not easy to travel. There still remain a lot of challenges facing the authorities in their future economic development.

The program undertaken now is undoubtedly a belt-tightening one, as evidenced by the drastic drop of the programmed imports to -5.8 percent from last year's 25.9 percent. Furthermore, it is encouraging to see that the real GDP will grow art the rate of 5./5 percent , better than those in previous year. Gaining the support of the Sudanese people for the program is another critical element to the final success of the program. I agree with Mrs. Guti in her helpful statement, that the recent payments performance and the satisfactory implementation of the program clearly indicate that the authorities' firm commitment on the repayment of the arrears and close cooperation with the staff under the monitored program have been widely supported and endorsed by the international community. So in such a situation I can support the proposed decision with the amendment proposed by Mr. Shaalan and join other speakers in wishing the authorities all the best.

Mr. Shields made the following statement:

I would like to associate myself completely with what Mr. Bernes had to say about Sudan's performance both recently and in the past, and about the need to go for a tighter program before we can be sure that Sudan justifies any further action by the Fund.

I am very pleased to see that Sudan has kept all its promises on payments to the Fund. We wondered at the Board meeting in March about how the payments were made in the first couple of months of the year, in particular, whether the payments to the Fund were made from Sudan's foreign exchange reserves or from a third party who had perhaps made special payments so that Sudan could meet its obligations. At that time, the Deputy Director of the Middle Eastern Department had said that the authorities were obliged to report all individual grants and credits and were not permitted to take on any new nonconcessional debt. Could the staff confirm that repayments have been made without any increase in Sudan's bilateral obligations?

On the process of fiscal consolidation, we hear reports that stringent measures have had to be implemented by Sudan. It will be beneficial if the fiscal consolidation can be structured in a way that protects social safety net expenditures, with reductions focusing on civil service reform and military spending. Perhaps the staff could provide more information on that, and whether it has any concern about governance issues.

Looking forward to the discussions for the Article IV consultation, I wonder whether we might look forward to a specific assessment of the social impact of the austerity measures, especially on the poorest members of society. I am particularly interested in looking at Sudan's food deficit. My authorities also have some concerns about the reliability of official data in Sudan, including the inflation numbers and the current account deficit. There is a 20 percent current account deficit with still large unidentified capital inflows.

Perhaps the issue of data deficiencies will be covered in the staff report for the Article IV consultation.

Regarding the draft decision itself, I am concerned about the formulation of paragraph 3. I would have liked the reference to have been to the fact that policies have been tightened, rather than that they actually have been tight. I would suggest some changes in that wording.

I do not think Mr. Shaalan's suggestion for a change with respect to a rights accumulation program will send the right message to Sudan. I would prefer to be specific about a staff-monitored program at this stage.

Mr. Goffinet made the following statement:

It is encouraging to note that even with an unpromising basis and difficult initial conditions, an effort of political will can be rewarded. In fact, Sudan has managed the double task of keeping up its required payments to the Fund while meeting the structural and quantitative benchmarks under the staff-monitored program. And as is fully documented by the staff report, Sudan's macroeconomic performance has really improved. A tight fiscal policy stance, prudent monetary and credit policies, and modifications of the exchange rate system have resulted in GDP growth which not only meets but exceeds the program target. Inflation, although still very high by international standards, has been significantly reduced, and Sudan's overall external balance has improved in spite of adverse external conditions.

But despite these positive signs, Sudan must overcome serious challenges before its economy can reach a sound and sustainable growth path enabling the authorities to begin thinking about poverty reduction. Serious economic distortions remain, and the political situation is still fragile even after ratification of the peace agreement. We therefore urge the authorities to strengthen the present stance of their policies still further, in order to realize the significant improvements in the economic situation that will follow the vigorous completion of the staff-monitored program.

The staff paper correctly identifies the main challenges for the second half of 1997. In the fiscal area, extremely low budget revenues, which amount at most to 7 percent of GDP and are expected to fall short of target, and an overall fiscal deficit exceeding 10 percent of GDP, call for serious additional revenue measures and tight expenditure controls. The midyear supplementary budget is commendable, but it will do little to help the fiscal situation. We can only urge the authorities to proceed with the planned modifications of the tax system and tax administration, including introduction of a value-added tax. Tight fiscal policies, combined with continued prudent monetary and credit policies, will further strengthen the anti-inflation effort and help mitigate the effects of the worsened terms of trade. In addition, faster progress in narrowing the spread between the regulated and market exchange rates, and installation of an efficient interbank market and regulatory framework will also help improve Sudan's competitiveness.

As to Sudan's payments to the Fund, we note that although the authorities have stuck to their schedule, Sudan's arrears are still immense. I urge the authorities to continue the strict observance of their payment commitments to the Fund. Indeed, we would be glad if it were possible to accelerate payments ahead of the present schedule, perhaps even including repayment of some arrears of principal in addition to interests. Combined with a strict and steadfast adherence to the arranged program, we are convinced that Sudan will continue to improve its relations with the Fund and with its other external creditors.

The positive course of events since February 1997, and the authorities' determination to achieve the objectives of their ambitious program, lead me to endorse at this stage the proposed decision, knowing that the Board will review the decision within six months and than decide what further course of action to take in Sudan's case.

Mr. Merino made the following statement:

We note that the Sudanese authorities have used the last opportunity given by the Board to cooperate with the Fund in implementing the largely expected initial setup measures to address Sudan's severe economic and financial imbalances. We expect the remainder of the committed payments for 1997 to be made, and that a more ambitious and workable schedule will be worked out for the coming year. We hope that 1997 becomes the year that the Sudanese authorities can finally curb the increase in the stock of arrears to the Fund. In this regard, I would appreciate clarification from the staff whether after December 1997 Sudan is going to continue to pay the small monthly amounts to stabilize arrears to the Fund in SDR terms, or whether that is to happen only in 1998, following the Article IV consultation.

We broadly concur with the staff appraisal. Members must show that it is possible to emerge from arrears and overcome difficult economic situations. There must be a recognition that the adoption of a comprehensive framework of adjustment policies is ultimately in the country's best interest, and that it must be followed by a sustained effort of policy implementation. In this regard, the authorities' intention to consolidate the gains by strengthening the stance of the current policy is a good sign. However, a more ambitious policy and structural adjustment effort will be needed to ensure Sudan's economic viability.

In particular, we strongly encourage the authorities to accelerate their reforms in the exchange market for preparation of a unified market-based exchange rate system, and to deepen structural reforms in the oil and banking sectors and in tax policy and regulation, supported by a firm credit stance.

The second phase of the privatization program should be managed flexibly, with recourse to appropriate financial and operational restructuring modalities, to ensure success in a complex environment. We would appreciate staff comments on the kind of technical assistance the Sudanese authorities are receiving for the second phase, and more broadly, for their action plan for structural reforms.

In conclusion, in light of the government's efforts to move toward normalizing financial relations with foreign creditors, and the close monitoring that is envisaged to help the authorities keep the program on track, we support the proposed decision.

Mr. Wijnholds stated that one of the year's more pleasant surprises had been the turnaround in the Sudanese economy. It seemed that the Board had done the right thing by giving the Sudanese authorities one more chance, and they had grasped the nettle. At the same time, it needed to be borne in mind that some of the relatively good performance was due to special factors, such as favorable weather conditions and low oil prices. Nevertheless, real progress seemed to have been made, which he welcomed very much.

There was still a long and difficult road ahead, Mr. Wijnholds concluded, and he would, therefore, urge the authorities to continue and intensify the process of economic adjustment in close cooperation with the staff. He would join others in paying a compliment to the staff for its very effective and intensive work. He agreed with those speakers who had argued that it was too early to make mention of a possible rights accumulation program. The Board needed to look first at how the Sudanese authorities would perform in the coming months. By that time, the Board might also have a clearer picture of the possibility of putting oil proceeds in an escrow account, which had been mentioned before.

Mr. Mozhin made the following statement:

I would like to express my satisfaction with the recent steps taken by the Sudanese authorities toward normalizing their relations with the Fund. I am in favor of continuation of the dialogue between the authorities and the Fund. I thank the staff for its constructive involvement in the preparation and monitoring of the economic program in Sudan.

In the external sector, one of the most obvious problems in the Sudanese economy has been the existence of multiple exchange rate practices. This has been the reason for the existence of implicit fiscal revenues and subsidies. In 1997, however, the authorities have achieved commendable progress toward eventual elimination of this practice.

I would not be too much concerned about the increase in the average tariff level in Sudan. Income taxes are an important source of revenues in many developing countries. In the case of Sudan, broadly based and uniform tariffs are certainly a better alternative for foreign trade taxation than the regime of multiple exchange rates. Simplification of the import tariff structure and eventual elimination of the export levies must certainly be a priority for the Sudanese government. The authorities have already made the first steps in the right direction, and I strongly encourage them to deepen the reforms in the external sector.

I recall that at our March meeting, several Directors were rather skeptical about the chances of implementing step-by-step changes in the external sector proposed by the authorities and supported by the staff. I am pleased to see that this strategy seems to be working, and I once again endorse its use as originally planned.

Another major concern at our March meeting was the pricing of petroleum products. According to the staff, during the implementation of the first stage of the program, the government's involvement in oil imports has declined, and the share of the private sector has increased. The introduction of the price adjustment mechanism eventually led to a realignment of domestic and international prices for petroleum products. Following the program, the government has prudently accumulated profits from domestic petroleum sales at prices above the international level in a special reserve fund. I would like to hear from the staff whether the price adjustment mechanism is being implemented as originally intended. In Chart 4, depicting the evolution of petroleum prices, it looks like the domestic prices have remained constant from February and March until July.

As for the fiscal area, I noted the improvement in budget management and monitoring. Introduction of effective expenditure controls and inspection efforts have certainly contributed to somewhat better fiscal performance than was expected. What is more important, the close attention to the implementation of the budget fosters transparency and discipline in the government organizations. According to the staff, the authorities have been able to combine their efforts aimed at achieving specific short-term fiscal targets with some strategic planning in the fiscal area. That includes the future introduction of a value-added tax.

Similar adherence to the program is evident in monetary policy. Inflation fell sharply, as it has declined to 37 percent on a year-on-year basis in July. This level is significantly lower than the one originally envisaged under the program. Also, the authorities kept their promise with respect to adjusting the cost of borrowing. The average level of this cost in nominal terms has reached 70 percent. Of course, the Board urged the authorities to increase the cost of borrowing, as well as the returns on deposits when inflation was at a much higher level. Now that the rates of return have become strongly positive in real terms, my question is, what are the staff's views on the developments in this area?

In light of the progress made by the authorities in 1997, I do not regret the decision made by the Board in March to continue the dialogue with the authorities. At the same time, the message to the authorities should remain clear. I expect them to respect this institution's preferred creditor status and to comply with their financial obligations. The Sudanese authorities seem to be on the right track now, and I appreciate their effort. I hope they will build on their initial success. Only consistent performance by Sudan can pave the way for a strategy of normalization of its relations with the Fund. I can support the decision as suggested in the staff paper.

Ms. Cilento made the following statement:

We agree that the authorities' adherence to the staff-monitored program marks an improvement in cooperation with the Fund, and this is truly welcome, but the improvement in performance over the past month must be seen against the background of the authorities' longer-term track record. The challenge for the authorities is clearly to strengthen performance and their payments record. Further progress could form the basis of a program that could be monitored by the Fund. Like Mr. Newman and others, I think that the draft decision could be tightened up to better reflect this. I agree with Mr. Shields that the changes to the decision proposed by Mr. Shaalan could send the wrong signal at this very early stage in normalization of relations between Sudan and the Fund.

Mr. Kaeser made the following statement:

Sudan seized the last opportunity to avert compulsory withdrawal from the Fund by making monthly payments to the Fund through July as committed and by observing all quantitative benchmarks through June and structural benchmarks through July under the staff-monitored program. Sticking to the program improved macroeconomic performance: real GDP grew more than initially projected whereas inflation declined more rapidly than envisaged. The overall external balance improved also due to sizable remittances and private capital inflows. Part of the good performance in the last three months, however, was due to favorable seasonable factors. One has also to consider that the staff-monitored program so far was of very short duration and not very ambitious.

Given these developments we agree not to proceed with the recommendation to the Board of Governors regarding Sudan's compulsory withdrawal at this time. However, we would like to restate in plain terms, that if in the period before the next review Sudan fails to implement the program satisfactorily or does not make its committed monthly payments to the Fund, we would immediately ask for a recommendation of compulsory withdrawal by the Executive Board to the Board of Governors. We expect from the staff to continuously monitor Sudan's program and to report to the Board on performance on a monthly basis.

For the second half of 1997 we, therefore, encourage Sudan to comply with the staff-monitored program and accelerate its implementation as well as increase payments to the Fund, if possible, in order to establish a track record. The steadfast implementation of macroeconomic and structural reforms is also indispensable because macroeconomic imbalances are still very large. More specifically, for the next six months we request progress in the following areas of importance:

Fiscal policy: The approved additional revenue measures combined with tight expenditure controls are necessary to stick to the original program target for the overall budget deficit. However, the end does not justify the means. Distortional elements such as the increase of tariff rates should be eliminated by the end of the year and replaced by other measures, namely the value-added tax. The planned introduction of the value-added tax in the beginning of 1998 is also important because revenue collection as a percentage of GDP is very low. Moreover, we expect that petroleum prices are adjusted on a regular basis in order to avoid a decline below international prices as well as a need for subsidization. The next step should now be to enhance the role of the private sector in importing and marketing petroleum products.

Monetary and credit policy: In order to consolidate progress in reducing inflation, broad money growth should continuously be restrained by a tight credit stance which must include positive real interest rates. Like the staff, we consider the introduction of new government borrowing instruments an important measure to improve the functioning of the banking system.

Exchange rate: Exchange rate reforms led to higher than programmed foreign exchange inflows and improved the overall balance of payments. However, the spread between the official and parallel exchange rate is still large though somewhat lower than requested under the staff-monitored program. We strongly welcome the authorities' intention to accelerate the pace of reduction in the spread. We also encourage a further early reduction of surrender requirements. Looking at the balance of payments we notice that "errors & omissions and other private capital" are only slightly smaller than the trade balance. Could the staff explain why it rose strongly in the last year and whether it has more information about this category?

Regarding the medium-term framework we consider it important that the 1998 program contains a substantially more ambitious policy and structural reform efforts. We would also find it unacceptable that monthly payments to the Fund only continue at the current level as they only stabilize Sudan's arrears to the Fund but do not substantially reduce them. We support the staff's intention to take up the Minister of Finance's proposal to use part of the windfall in the oil sector to accelerate repayments to the Fund by setting up an escrow account.

After a long time of persisting non fulfillment of its obligations under the Articles of the Agreement, it is important that Sudan establishes a track record in view to normalize the relation with the Fund. The short experience under the current program is not sufficient to allow to talk already about the possibility of moving to a rights accumulation program. We take the view that such a move should be considered only on the basis of a longer and solid track record, and, furthermore, after a substantial reduction of Sudan's arrears to the Fund.

Ms. Pinzani made the following statement:

We welcome the results achieved by Sudan. However, we cannot agree with Mr. Shaalan's proposal, since the Fund's cooperation cannot be stretched to the point of offering new resources to Sudan at this stage. Eleven years of bad performance cannot outweigh less than six months of performance that is "broadly" in line with the staff-monitored program.

Like Messrs. Esdar and Shields, we also would like to underscore the fact that, on this ninth occasion on which consideration is being given to Sudan's compulsory withdrawal from the Fund, offering the country a new period of staff monitoring is per se a big vote of confidence in the Sudanese authorities. We urge the authorities to implement fully the program in the remainder of 1997. We could agree to a decision that would specify better the nature of the program envisaged for 1998. That program must be a staff-monitored program.

Mr. Jourcin stated that he welcomed Sudan's performance, which had been brought into line with the program. That was a good first step. He congratulated the staff for the work it had done on the monitoring. He supported the proposed decision.

Mr. Fujii made the following statement:

Like other speakers, It is commendable that following the decision adopted by the Executive Board on February 12, 1997, Sudan has started timely payments to the Fund in accordance with the monthly schedule and has satisfactorily implemented the staff-monitored program. I can therefore support the proposed decision not to proceed with the recommendation for the compulsory withdrawal of Sudan to the Board of Governors.

At the same time, however, I would again mention that this improvement is the first step to create a good track record and that we are still in a position to consider the recommendation of compulsory withdrawal unless the authorities continue to demonstrate good performance in repayment and policy implementation. In this regard, as Mr. Shields and other speakers proposed, I would argue that some modification of the proposed decision to maintain the authorities' reform momentum as well as to take into account a possible extension of the staff-monitored program in 1998 should be considered.

Let me make some brief comments on specific policies.

It is welcome that the Minister of Finance expressed his authorities' readiness to use the windfall in the oil sector so as to accelerate the repayments to the Fund. I urge the authorities to strengthen their efforts and make further repayments.

It is encouraging that inflation has been significantly reduced in recent years, however it is still relatively high. I would emphasize that the authorities need to lower inflation to the single-digit level through fiscal consolidation and tightening of monetary policy.

On the exchange system, it is commendable that the authorities have moved toward unification of exchange rates albeit gradually. However, as the staff pointed out, I hope that the authorities will achieve early unification of the exchange rates by accelerating structural reforms in the financial sector such as deregulation and establishment of an appropriate supervisory mechanism.

With these remarks, I wish the authorities every success.

The Deputy Director of the Middle Eastern Department recalled that the question had been raised as to why the authorities did not wish to adjust the inflation target even though there had been a substantial reduction in inflation over the preceding few months. The authorities did not wish to state a specific inflation target in the program; however, they had agreed to a range of 50–55 percent, which the staff considered reasonable. The authorities did expect a significant reduction in inflation from the originally specified target. They had in fact tightened policies in comparison with the original program, to ensure that a substantial reduction in inflation would be achieved—in the range of 40–45 percent. The actual outturn might be lower or higher depending upon what would happen with some of the administered price increases, which were just beginning to be adjusted.

There was also uncertainty related to how fast the exchange rate would be adjusted, the Deputy Director pointed out. The authorities had agreed to accelerate the depreciation in the official rate in order to compensate for the impact on the balance of payments owing to the terms of trade shock, which had been more serious than initially projected. That would have an impact on prices. There was also considerable uncertainty in the behavior of velocity. Taking those factors into account, the staff believed that it should go along with the authorities' view not to specify an inflation number, but the objective would be to achieve a substantially lower rate of inflation by sticking to the policy stance and tightening policies further as envisaged in the program.

Regarding the exogenous factors that had had an impact on performance, the higher rate of growth of 5.5 percent that the staff was projecting was owing partly to good weather, and partly to continuing efforts to improve the irrigation systems, the Deputy Director added. The decline in the oil price had also clearly been a benefit in the beginning, which had contributed to both some budgetary revenues and the buildup of the petroleum price stabilization fund. That had slowed the growth in reserve money—but that effect would be reversed, as an increase in oil prices was being projected in the second half of the year. What was more important, the prices of some important exports had dropped sharply, with a massive, and more than anticipated, deterioration in the terms of trade. Those factors were pulling in different directions. It should be acknowledged, nevertheless, that the policies would contribute significantly to the outcome, not just exogenous events.

Ms. Srejber commented that she was somewhat confused about the inflation target for the end of the year. She wondered whether the administrative price hikes that had been mentioned constituted a new measure that had not been in the original plan for the staff-monitored program.

The Deputy Director of the Middle Eastern Department explained that the staff had been aware that the price hikes were coming, but had not known the precise timing of implementation in 1997. Electricity prices had been increased by 300 percent in July, and water charges were to be increased in August. The staff knew also that the initial increases in oil and other prices would eventually be passed through. There had also been seasonal increases in prices for meat and vegetables, which generally occurred in the second half of the year. The program incorporated an assumption of greater inflation in the second half of the year than the first, but there was an element of uncertainty as to the precise magnitude.

Ms. Srejber said that she wondered why setting a specific inflation target for the end of the year presented a problem.

The Deputy Director of the Middle Eastern Department replied that the staff had agreed with the authorities on a specific target for the end of the year—55 percent—for the purpose of setting program benchmarks. That target took into account the projected acceleration of inflation in the second half of the year. The authorities agreed that, with the policies specified in the program, the rate could turn out to be lower depending on inflation expectations and other factors, but they were not willing to specify in their letter of intent a particular number for inflation.

Ms. Srejber said she continued to wonder why the authorities were reluctant to have a specific inflation target that took into account the more positive developments thus far.

The Deputy Director of the Middle Eastern Department replied that the wording of the letter of intent was that inflation would be reduced significantly below 65 percent. The authorities believed that, if the inflation performance turned out considerably better than initially targeted, it would be politically advantageous to them. The wording on inflation in the letter of intent had not been a major issue in the staff's initial debate with the authorities, since there was full agreement on the inflation target underlying the program benchmarks..

Mr. Esdar commented that, especially in the case of Sudan, it was important to get a clear picture of performance under the program. In that regard, it was hard to work with a moving target. The improved performance should have been reflected in a reduced target for inflation. He wondered whether the deterioration in the terms of trade—by about 12 percent—could be explained in part by the process of exchange rate unification and consequent devaluation. Perhaps the improvement in the competitive structure and the efficiency of product markets had been offset by the more realistic exchange rate.

Mrs. Guti said that the authorities had agreed with the staff on an inflation target, which took adequately into account Sudan's circumstances.

Ms. Cilento said that she wished to subscribe to Mr. Esdar's comments. Performance criteria should be realistic but ambitious. The kind of specification that the authorities had given made it more difficult for the Board to have a real sense of how the program was going.

The Deputy Director of the Middle Eastern Department reiterated that the revised program for the second half was based on an inflation target of 55 percent. The initial target had been 65 percent. The only issue was whether they wished to mention the 55 percent target. If the inflation performance was better, they wanted to surprise the public with that. The fact that the authorities had not specifically mentioned a number in the letter of intent, which they needed for distribution internally, was not critical.

The 12 percent deterioration in the terms of trade would probably increase the current account deficit by 0.6 percent of GDP, but offsetting policy measures that the authorities could take would ameliorate that by about half, the Deputy Director said. The improvement in the current account deficit—originally anticipated at 2.3 percent—would therefore be lowered to only 2 percent. The offsetting policy measures included faster convergence of the official exchange rate to the free market rate, a change in the retention ratios for a range of commodities—so that a larger share of exports could access the free market rate as opposed to the official rate—and more tightening of monetary policy than in the initial program. Credit expansion for the full year had been reduced by the equivalent of about 0.2 percent of GDP.

For the purposes of the 1997 program, the authorities had committed themselves to accelerate the convergence of the official rate to the free market rate, to a spread below the targeted 8 percent by the end of the year, the Deputy Director stated. At the end of August, that spread had reached 8.6 percent. The rationale was to depreciate the official rate faster than initially envisaged in order to partially offset the larger than expected deterioration in the terms of trade. While the authorities did not want to pin down a number at the present juncture, there would be a significant closing of the gap in the exchange rates.

The exchange market unification had required a variety of structural reforms, which had already been put in place, of which the more important were monetary reforms, as well as the ability to sustain the fiscal adjustment for which the various tax reforms were being planned, the Deputy Director observed. In September 1997, the staff expected to see some progress in developing more active, market-based instruments of monetary management under Islamic banking principals. Another important factor to ensure the sustainability of the exchange market unification would be the development of an appropriate regulatory regime. Currently, there were two exchange markets: the account-to-account market, which was completely free of restrictions with regard to capital account transactions, and the official dealer market, which was limited to intermediating a set of specified current account transactions. There were different regulations for each market. For unification, a common set of regulations would be needed. The staff was working on such a harmonized regulatory framework with the authorities, on which the staff hoped to be able to report to the Board more fully at the time of the coming Article IV consultation discussions. It needed to be borne in mind that it would be unreasonable to expect a sudden, forced unification of the rates, and an instant opening of the capital account without any safeguards. When the authorities had opened the capital account before, they had had to reimpose the surrender requirements within a few months.

Ms. Srejber said that she was still confused, but that was not the fault of the staff.

Mr. Mirakhor noted that the paper on the staff's review of the staff-monitored program had said that while the initial inflation projection of 65 percent had not been explicitly revised by the authorities, it was expected that the inflation outcome would be about 55 percent, and the program projections for the second half had been revised accordingly. In his view, the staff had been quite clear on the matter, as it had been on how the deterioration of the terms of trade would be taken into account in the adjustment of policies in the external sector.

With regard to a question raised by Mr. Shields, Mr. Mirakhor concluded, he could not imagine what difference it made as to the exact origin of the resources that Sudan was using to repay the Fund. Either the resources came from grants, in which case there were no additional liabilities, or from borrowing. If the resources came from borrowing, then it could be assumed that the authorities were borrowing from others to repay out of respect for the Fund's preferred credit status.

Mr. Shields replied that he had raised that question because of the comments that had appeared in the press at the time of the preceding Board discussion of Sudan regarding bilateral resources. At that time, the Board had asked for some elaboration on that from the Minister, who had given an unhelpful response, and the staff had said that it could not clarify the situation. Perhaps more information had become available on that point since the previous discussion. On that basis, he wished to reiterate his question.

His interest in the origin of the resources that Sudan was using to repay the Fund related to the fact that the Board was considering a complaint about compulsory withdrawal for Sudan, and Sudan had had an appalling payments record, Mr. Shields explained. The Board had listened many times to explanations of why Sudan had been unable to make payments to the Fund, so, when it did manage to make a payment, it seemed reasonable to ask where it came from. The source of the repayment money was relevant as well to the current program. The Board needed to be able to make an assessment of whether the new obligations into which the country was entering were consistent with the program.

Mr. Esdar said that he agreed with Mr. Mirakhor that the source of the repayment money was not very important. What was important, however, was that the Board have a clear view of the evolution of the balance of payments situation, the debt structure, and financial flows. The answer the Board had received at the preceding meeting on Sudan on those points had not been acceptable. The Articles of Agreement made it incumbent upon members to provide the Fund with a clear and full picture of the balance of payments, and it was from that perspective that the question of Mr. Shields was being posed.

Mr. Mirakhor responded that there did not appear to be any lack of clarity in the figures in the balance of payments data that the staff had provided.

Mr. Esdar replied that he would make no judgment as to the clarity of the balance of payments statistics, but the inadequate answer that had been given in reply to a legitimate question from the Board gave the unavoidable impression of a lack of transparency on the part of the country concerned.

Ms. Srejber commented that it was natural for the Board to want some additional information in order to come to a sound decision, especially as some revisions to the draft decision were being suggested. Perhaps Mr. Mirakhor could take the comments of Mr. Shields and Mr. Esdar in that light.

Mrs. Guti remarked that she hoped that the Board was focusing objectively on the progress that Sudan had made thus far under its program, and not on what had happened at a previous Board meeting. In any case, from her recollection of that meeting, she would not consider unsatisfactory the answer that had been given by the Sudanese Minister. The source or character of bilateral assistance provided to Sudan was not the concern of the Board, in her view. The Board had not gone into that question in the cases of other countries in arrears to the Fund.

Mr. Shaalan commented that the Board should concentrate on whether the funds used to repay the Fund had given rise to a commercial, nonconcessional debt. The Board had every right to know whether the authorities had abided by their obligation not to incur additional nonconcessional debt.

Mr. Shields said that the question of the source of bilateral assistance was related to the fact that the Board was trying to find ways to encourage Sudan to improve its economic policies and make payments to the Fund. In that respect, the Board was looking to Sudan's friends as well to give Sudan the same encouragement. He would agree that that expectation appeared to have borne fruit.

Mr. Esdar commented that the question of the source of the funds must be seen against the background of the balance of payments, the size of the errors and omissions accounting, and the fact that private capital flows were large in comparison with total exports. Those factors also gave rise to questions.

Mr. Mirakhor pointed out that, with regard to the question of transparency of the balance of payments data, statistical reporting had been a structural benchmark of the program, and the staff had reported that it had been observed at the end of July. If the benchmark had been observed and the staff had already testified to that, he wondered how anyone could raise a question about the transparency of the data.

The Deputy Director of the Middle Eastern Department stated that the reporting requirement for the balance of payments data was specified in one of the appendixes in the report. The authorities had said, and the staff confirmed, that no new nonconcessional borrowing had been undertaken. The grants and loans were primarily project aid. In the first half of 1997, the African Development Fund had made Sudan a project grant of $0.4 million, and the International Fund for Agricultural Development (IFAD) had made Sudan a loan of $8 million. There had also been some suppliers' credit and other trade-related short-term capital inflows in respect of the Bank of Sudan. The staff was monitoring the flow of funds through the Bank of Sudan, in terms of the types of foreign exchange receipts and expenditures. The main source of foreign exchange was the export surrender requirements; the Bank received about 36 percent of the total of foreign exchange by that method. There were also some taxes on expatriates, but that amount was small. About 23 percent of the foreign exchange received by the Bank of Sudan was from various short-term facilities with other correspondent banks. The Bank of Sudan used its foreign exchange chiefly to pay for petroleum imports, with the remainder going to pay the Fund. In February–March 1997, Sudan had paid $15.3 million to the Fund by using a supplier's credit in the form of a short-term loan from one of the foreign banks. In the same period, Sudan had disbursed about $4 million for imports of petroleum. Having said that, it was difficult to know which money had been used for which purpose. However, the increase in supplier's credit in February, which had enabled the authorities to make the payment to the Fund, had not created any problems for the benchmark in the program for nonconcessional borrowing. The supplier's credit was short term and trade related, and such credit was excluded from the benchmark and had probably already been repaid.

Mr. Kafka commented that he believed that more recognition to Sudan should be given in the text of the proposed decision. The Fund should always be more impressed by repentant sinners than by consistent saints.

The Deputy Director of the Middle Eastern Department reiterated that all quantitative benchmarks on the monetary side for the second half of 1997 had been set, on the basis of 55 percent inflation, as agreed with authorities. Concerning the reliability of the data, the Fund had fielded three missions thus far to improve data quality. There had been at least two missions from the Statistics Department to examine, inter alia, government finance statistics and the monetary statistics. Any data reliability problems grew out of inadequate institutional capacity. It was true that accounting errors of various types could occur, but they were generally corrected, and the system was fundamentally sound. The large errors and omissions and large current account deficits needed further analysis, however, and the staff would address those issues in the context of the forthcoming Article IV consultation.

Regarding the state of governance in Sudan and the need for civil service reform, it needed to be borne in mind that the institutional capacity in all areas was severely stretched, and there were not enough well-qualified people in many areas, the Deputy Director pointed out. The staff had accordingly complemented its policy advice with as much technical assistance as it could mobilize. Strengthening the institutional capacity was the key to governance. On their own, the authorities had tried to improve the accountability of the various systems; for example, there was now a system for quarterly reporting to the parliament on budgetary outcome and public scrutiny of the budgetary measures. Internal monitoring and control procedures within the ministries and government departments were being strengthened. The availability of information to the public had been improved, and efforts were being made to improve the accountability of government actions. In addition to regulations regarding public disclosure and reporting to the parliament with respect to the budget, disclosure of banking information in conformity with Islamic banking principles was under consideration.

The strengthening of internal monitoring procedures was the key civil service reform at the present juncture, the Deputy Director continued. It was clear that mechanisms to monitor the activities of the public enterprises were needed, to ensure, inter alia, that profits and revenues were recorded and transferred properly. For that purpose, an additional organization was being established under a new minister of state for finance. Similarly, accounts monitoring units were being established in different government departments to ensure expenditure control and the timely transfer of revenues. The Fiscal Affairs Department had scheduled a technical assistance mission on expenditure management and control in the following month, pursuant to the authorities' request.

Concerning the payments schedule beyond 1997, the authorities' commitment to strengthen cooperation was very clear, the Deputy Director emphasized. The staff would discuss a precise schedule of payments in the context of the Article IV consultation discussions. By that time, the staff would have the benefit of projections of the balance of payments and the extent of additional adjustment, which would provide the proper background for discussing the 1998 payments schedule.

Regarding an escrow account based on the oil export proceeds, while pipelines from some areas of oil extraction to the refineries were being completed, the pipeline to Port Sudan would not be completed until the latter part of 1999, the Deputy Director stated. Significant oil exports were likely to begin only after 1999. Although some early benefits from the oil extraction might be expected in terms of reduced imports once the pipelines between the oilfields and the refineries were completed, the likelihood of long-term benefits coming from expanded oil exportation was still extremely uncertain, as the size of additional oil production was not known. The staff was nevertheless discussing with the authorities how best to arrange the institutional mechanisms for benefiting from oil exports and accelerating the repayment of arrears to the Fund on that basis.

The petroleum price adjustment was being implemented as envisaged, the Deputy Director confirmed. The formula for the adjustment was such that if international oil prices declined, there need not be an immediate parallel downward adjustment in the domestic price, as had been the situation over the preceding few months. When international oil prices increased, the domestic oil price need not be increased immediately, if the price differential was within 3 percentage points. Domestic prices would, however, increase further if it were determined that balances in the petroleum stabilization fund were not sufficient to allow the continued postponement of the price adjustment. The authorities' goal was to build up the stabilization fund, which the staff supported, because it would have a significant monetary effect.

Replying to a question from Mr. Mozhin, the Deputy Director explained that while interest rates were strongly positive in real terms, the staff believed that it was too early to reduce nominal interest rates. Inflation expectations were still high. Interest rates on a year-to-year basis had fallen, but inflation on a month-to-month basis was accelerating. Moreover, while lending rates were positive in real terms, deposit rates remained negative. The staff had advised the authorities that the reduction in inflation should be sustained before interest rates were adjusted.

The staff representative from the Treasurer's Department, turning to the text of the proposed decision, said that paragraph 2 of the previous decision relating to the question of the compulsory withdrawal of Sudan had not been repeated in the proposed decision. Nevertheless, there should be no doubt that that paragraph remained in effect, even though the staff had not repeated it. The other operative elements of the earlier decision were contained in paragraph 4 of the proposed decision.

Mr. Newman said that the proposals of his colleagues relating to the formulation of paragraph 3 were similar to those he was going to make. With regard to the previous decision, like Mr. Esdar, he had been somewhat struck by the failure to incorporate paragraph 2 of the earlier decision into the current decision, particularly since the February decision had been the work of such a carefully balanced and nuanced negotiation. It would have made sense to incorporate paragraph 2 into the decision as well. However, in light of the staff's assurance that that paragraph still remained operative, he would not insist that the wording be incorporated into the present text.

Mrs. Guti said that she hoped that the decision would reflect the progress that had been made by Sudan, and the tone of the staff paper. She did not believe that paragraph 2 in the previous decision was consistent with that progress. Mr. Kafka had made some useful drafting suggestions, and the suggestion of Mr. Shaalan was also pertinent. While paragraph 4 did not recommend compulsory withdrawal, the decision continued to threaten compulsory withdrawal if Sudan's satisfactory performance did not continue, yet was mute on the question of what would happen if performance continued to be satisfactory. Mr. Shaalan's proposed amendment should be seen in that light. If the decision was to be credible, it had to cover either eventuality.

Mr. Newman said that he wondered whether Mrs. Guti believed that paragraph 2 of the earlier decision no longer applied.

Mrs. Guti said that she did not believe that the paragraph remained appropriate. The paragraph said that Sudan persisted in not fulfilling its obligations, which implied that the country had done nothing at all.

Mr. Newman recalled that part of the agreement at the time of the previous decision was that the decision would be accepted by all Directors unanimously, and that all Directors were agreed that that provision applied.

Mrs. Guti agreed that it had been unanimous at that time. However, it was not appropriate at the present juncture to repeat that assessment, because the authorities had shown their commitment to meeting their obligations since then. To include that provision would give the authorities no credit for what they had done since the preceding Board meeting on Sudan.

Mr. Newman remarked that his understanding was that as long as Sudan was in arrears to the Fund, it had not met its obligations.

Mr. Kaeser noted that the paragraph stated—for the fourth time—that the Fund would not pursue the course of compulsory withdrawal. The substance of paragraph 2 of the previous Board discussion on Sudan was fully integrated into paragraph 4, in his view.

Mr. Esdar commented that he was satisfied with the staff's indication that the legal implications inherent in the previous paragraph 2 continued to be relevant, and from that perspective, he was surprised with the tack that the discussion had taken. If, however, the staff were to say that the previous understanding related to paragraph 2 no longer applied, then he would wish to reconsider his position.

The discussion then turned to the draft decision, and five amendments were proposed and discussed.

In paragraph 2, Mr. Kafka proposed the addition in the first sentence of the words "with satisfaction" so that it would begin "The Fund notes with satisfaction . . . ." That proposal was accepted. He also suggested that in the second sentence the word "notes" be replaced by "is pleased to note" and that also was accepted.

In paragraph 3, Mr. Shields suggested that in the first sentence the phrase "the authorities' maintenance of a tight fiscal policy, prudent monetary and credit policy..." be replaced by "the authorities' tightening of fiscal, monetary, and credit policies..."; that suggestion was supported by Ms. Srejber and Messrs. Bernes, Esdar, Fujii, and Newman, opposed by Mrs. Guti and Mr. Mirakhor, and was accepted. As regards the third sentence, dealing with the Fund's encouragement to the Sudanese authorities to enter into discussions on a further strengthening of policies and payments to the Fund, Mr. Shaalan proposed the inclusion of a reference to the possibility of a "rights accumulation program": that proposal was supported by some Directors (Messrs. Disanayaka, Han, Ismael, and Mirakhor) and opposed by others (Ms. Cilento, Ms. Pinzani, and Messrs. Esdar, Kaeser, Newman, Shields, and Wijnholds) and was not accepted. Instead, Mr. Shields proposed that the sentence contain a reference to a possible "staff-monitored program" in 1998: that proposal was supported by some Directors (Ms. Cilento, Ms. Pinzani, Ms. Srejber, and Messrs. Bernes, Esdar, Fujii, Levy, and Newman), and explicitly opposed by others (Mrs. Guti, and Messrs. Mirakhor, Shaalan, and Zamani), while several other Directors would have preferred to retain the original wording proposed by the staff. As a majority of the voting power supported the amendment proposed by Mr. Shields, it was accepted.

The Executive Board took the following decision:

1. The Executive Board has reviewed Decision No. 11441-(97/13), adopted February 12, 1997. The Board has also considered further the Managing Director's complaint under Article XXVI, Section 2(c) dated April 8, 1994.

2. The Fund notes with satisfaction that payments to the Fund by Sudan have been in line with the schedule committed to by the authorities since the last review. The Fund is also pleased to note that macroeconomic performance in this period has been broadly in line with the program as described in EBS/97/45, and the program quantitative benchmarks through June and structural benchmarks through July were met.

3. The Fund welcomes, in particular, the authorities' tightening of fiscal, monetary, and credit policies, and progress toward unification of the exchange system. The Fund stresses that continued firm implementation of the program will be necessary in the remainder of 1977 and encourages the authorities to consolidate these gains by proceeding to strengthen the stance of fiscal and credit policies, accelerate the convergence of the exchange rates, and expedite structural reforms. The Fund also encourages the authorities to enter into discussions with the staff on a further strengthening of policies and payments to the Fund that could provide the basis of a staff-monitored program in 1998. In this regard, the Fund emphasizes the importance of the authorities' efforts to enhance relations with external creditors and donors.

4. The Executive Board finds that Sudan has met the requirements set out in paragraph 3 of Executive Board Decision No. 11441-(97/13), adopted February 12, 1997, in the areas of payments to the Fund and adoption and implementation of a program of economic adjustment of a quality that warrants staff monitoring. Therefore, the Executive Board will not at this time proceed to recommend the compulsory withdrawal of Sudan to the Board of Governors. However, if, in the period before the next review, Sudan fails to continue the satisfactory performance thus far, the Board will meet promptly to review the situation and recommend compulsory withdrawal to the Board of Governors.

5. The Fund will consider further the Managing Director's complaint under Article XXVI, Section 2(c) dated April 8, 1994 at the time of the Executive Board's conclusion of 1997 Article IV consultation discussions with Sudan, or within six months from the date of this decision, whichever is earlier, in the light of Sudan's performance in terms of continuing to meet the requirements under items (i) and (iii) in paragraph 3 of Executive Board Decision No. 11441-(97/13).

Decision No. 11566-(97/89), adopted
August 29, 1997

3. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Fayolle on the completion of his service as Alternate Executive Director for France.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/88 (8/27/97) and EBM/97/89 (8/29/97).

4. CENTRAL AFRICAN REPUBLIC—OVERDUE FINANCIAL OBLIGATIONS—REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Managing Director under Rule K-1 dated August 25 (EBS/97/162, 8/25/97) on the Central African Republic is noted. It shall be placed on the agenda of the Executive Board for October 3, 1997.

2. The Fund urges the Central African Republic to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule K-1 particularly affects the Central African Republic. The member shall be informed by rapid means of communication of this matter and of its right to represent its views through an appropriately authorized representative.

Decision No. 11567-(97/89), adopted
August 28, 1997

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/112, Supplement 3 (8/27/97) and EBAM/97/134 (8/27/97), and by Advisors to Executive Directors as set forth in EBAM/97/34 (8/27/97) is approved.

APPROVAL: March 12, 1998

REINHARD H. MUNZBERG
Secretary